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In the Supreme Court of the United States

OCTOBER TERM 1972

No. 72-810

R. L. GRAVES, FLORA J. GRAVES,
R. L. and FLORA J. GRAVES, and
SPARKS NUGGET, INC. as TRANSFEREE,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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INDEX

	Page
Opinions Below	1
Jurisdiction	2
Questions Presented	2
Statutes and Constitutional Provisions Involved	3
Statement of the Case	3
Reasons for Granting the Writ	6
Conclusion	19
Appendix A	1
Appendix B	48
Appendix C	63
Appendix D	64
Appendix E	67
Appendix F	93

CITATIONS

Cases

	Pages
Automobile Club of Michigan v. Commissioner, (1957) 353 U.S. 180	13
The Challenger, Inc., (1964) 23 T.C.M. 2096	3, 15
Commissioner v. First Security Bank of Utah, (1972) 405 U.S. 394	8, 11
Connecticut Ry. and Lighting Co. v. United States, Ct.Cl. 1956) 142 F.Supp. 907	13
Connolly v. General Construction Co., (1926) 269 U.S. 385	17
Cramp v. Board of Public Instruction, (1961) 368 U.S. 278	17
Eisner v. Macomber, (1920) 252 U.S. 189	3, 18, 19
Exchange Parts Co. of Fort Worth v. United States, (Ct.Cl. 1960) 279 F.2d 251	13
B. Forman Co., Inc. v. Commissioner, (C.A. 2, 1972) 453 F.2d 1144	9, 12
Helvering v. Griffiths, (1943) 318 U.S. 371	18
Holsey v. Commissioner, (C.A. 3, 1958) 258 F.2d 865	14, 16, 19
Huber Homes, Inc. (1971) 55 T.C. 598	9
International Business Machines Corp. v. United States, (Ct.Cl. 1965) 343 F.2d 914	12, 13
Kahler Corp., (1972) 58 T.C. 496	9
Kerry Investment Co., (1972) 58 T.C. 479	10
Lanzetta v. New Jersey, (1939) 306 U.S. 451	17
Niederkrome v. Commissioner (C.A. 9, 1958) 266 F.2d 238, rev'g T.C. Memo. 1956-255, 15 T.C.M. 1312	16

Pages

PPG Industries, Inc., (1970) 55 T.C. 928 9

Richard Rubin, (1968) 51 T.C. 251 7
Richard Rubin, (1971) 56 T.C. 1155 10
Rubin v. C.I.R., (C.A. 2, 1970) 429 F.2d 650 ..6, 7, 8, 10, 12, 14

Sammons v. United States, (C.A. 5, 1970) 433 F.2d 728 18
Seminole Flavor Co., (1945) 4 T.C. 1215 9
Smith-Bridgman & Co., (1951) 16 T.C. 287 9

Tennessee-Arkansas Gravel Co. v. Commissioner, (C.A. 6, 1940) 112 F.2d 508 9
Tucker v. Commissioner, (C.A. 8, 1955) 226 F.2d 177, rev'g 23 T.C. 115 16

United States v. Kaiser, (1960) 363 U.S. 299 13

Weller v. Commissioner, (C.A. 3, 1959) 270 F.2d 294 .. 13

CONSTITUTIONAL PROVISIONS

United States Constitution:
Amendment V 3
Amendment XVI 3, 18

STATUTES

Internal Revenue Code of 1939:
Section 45 9

Internal Revenue Code of 1954 (26 U.S.C.):
Section 61 ..... 2, 3, 6, 8
Section 162 ..... 2, 3, 4, 6, 7, 11, 13, 18
Section 163 ..... 2, 11
Section 165 ..... 2, 11
Section 269 ..... 9, 15
Section 301 17
Section 304 15
Section 315 17

Pages

Section 316 17
Section 318 17
Section 482 .....2, 3, 4, 5, 6, 7, 8, 9, 10, 11, 12, 13, 14, 15, 18
Section 1551 9
Section 1561 15

Treasury Regulations:
Section 1.482-2(C)(1) 7
Section 1.482-2(C)(2)(c) 7

Revenue Rulings:
Rev. Rul. 58-614 1958-2 Cum. Bull. 920 14

Revenue Procedures:
Rev. Proc. 64-54, 1964-2 Cum. Bull. 1008 10
Rev. Proc. 65-17, 1965-1 Cum. Bull. 833, amended 1966-2 Cum. Bull. 1211 10
Rev. Proc. 65-31, 1965-2 Cum. Bull. 1024 10

MISCELLANEOUS

7 Mertens, *Law of Federal Income Taxation,* p. 176 9

Nauheim, "B. Forman & Co.—A Crucial Test of the Future of Section 482", 26 *The Tax Lawyer* (Fall 1972) 12

In the Supreme Court of the United States

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No.

R. L. GRAVES, FLORA J. GRAVES,
R. L. and FLORA J. GRAVES, and
SPARKS NUGGET, INC. as TRANSFEREE,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

R. L. Graves, Flora J. Graves, and Sparks Nugget, Inc., as Transferee of The Challenger, petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Ninth Circuit in these cases which were consolidated in the courts below and present both identical and closely related questions.[1]

OPINIONS BELOW

The opinion of the Tax Court (Appendix A, *infra*, pp. 1-47. . . .) is a memordandum decision of that court (T.C.

1. Rule 23(5) of the Rules of this Court.

Memo. 1970-74) which is not officially reported but which is unofficially reported at 29 T.C.M. 318. The opinion of the Court of Appeals (Appendix B, *infra*, pp. 48-62) is reported at 458 F.2d 631.

JURISDICTION

The judgment of the Court of Appeals was entered on April 6, 1972 (Appendix B, *infra*, p. 48). A petition for rehearing was filed on April 20, 1972 and this was denied on September 11, 1972 (Appendix C, *infra*, p. 63). The jurisdiction of this Court is invoked under 28 U.S.C. Sec. 1254(1).

QUESTIONS PRESENTED

1. Whether Internal Revenue Code Section 482[2], conferring on the Commissioner the power to allocate gross income and deductions between commonly controlled business organizations, is exclusive or is rendered surplusage by an implicit but unexpressed power to accomplish the same intercorporate effect under Sections 162, 163 and 165, allowing the deduction of business expenses, interest, and losses from sales.

2. Whether the rule of decision that Section 482 authorizes the allocation of gross income but not its creation can be circumvented by the Commissioner's proceeding instead under Section 162(a) and Section 61, in the light of the rule that the Commissioner may not so administer the tax laws as to tax like persons differently.

3. Whether income in the form of a constructive dividend can be found to exist where the shareholder's only economic benefits are the unrealized appreciation of his corporate holdings and a corporate structure, having business purpose, which is capable of producing future benefits under the specific income tax laws Congress has enacted.

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2. All statutory references are to the 1954 Internal Revenue Code (26 U.S.C.) unless otherwise identified.

4. Whether penal taxation totalling 143 per cent can be based upon rules of decision not stated in the statute in a form sufficient to warn "men of common intelligence" of the penalized standard of conduct, in view of the due process requirements of the Fifth Amendment.

5. Whether taxable income can be found from economic benefits which are still locked up in corporate solution and which cannot be withdrawn without incurring a second tax, in the absence of a clear Congressional command to reexamine *Eisner* v. *Macomber,* (1920) 252 U.S. 189.

STATUTES AND CONSTITUTIONAL PROVISIONS INVOLVED

The statutes involved are Section 61, 162 and 482 of the 1954 Internal Revenue Code. The Constitutional provisions involved are Amendments V and XVI of the United States Constitution. All are set forth in Appendix D, *infra,* pp. 64-66....

STATEMENT OF THE CASE

Petitioners Graves are husband and wife residing in Carson City, Nevada. They owned, as community property, the entire outstanding stock in the following corporations: The Challenger, Inc.; The Pub, Inc.; United Waldorf, Inc.; Caldwell Sport Shop, Inc.; Saratoga Club, Inc.; and Sparks Development Company, all of them but the last having done business in Idaho before moving their assets and businesses to Nevada.[3] The Challenger established a legal gaming casino near Reno, Nevada, and by 1959 leased real property from the other corporations for the conduct of its business. It also leased slot machines from three of the four other Idaho corporations.

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3. Four of the five former Idaho corporations were either held or conceded to have dominant business purposes in a prior case. *The Challenger, Inc.,* T.C. Memo. Op. 1964-338, 23 T.C.M. 2096. Before trial in this case, the same concession was made concerning Sparks Development Co.

In a prior case[4] the Tax Court decided, *inter alia*, that the slot machine rentals exceeded fair rental value and that the excess was taxable to The Challenger and not to the corporate lessors, but it refused to decide whether it was proceeding under Section 162(a) or Section 482.[5] In explaining why the amounts it held nondeductible by The Challenger were not taxable to the three corporations which had actually received them, the Tax Court said that they could be either a tax nullity, or a capital contribution by The Challenger to the other corporations, or a constructive dividend to the Graves followed by a constructive capital contribution by them to the recipient corporations, and it need not decide which they were.[6] Only the last alternative would produce duplicate taxation of the same income, and the Commissioner embraced that alternative and asserted the duplicating tax against the Graves in this case.

The Commissioner applied the same technique to rentals paid by The Challenger to Sparks Development Co. for parking lots contiguous to the casino. He disallowed The Challenger's deduction for the portion he determined to be in excess of fair rental values but in conformance with the prior decision he did not assert a duplicating tax against the recipient corporation; he asserted it instead against the Graves. For the corporate adjustment he had relied on Section 482 in the prior case, and had attempted at the trial to assert Section 162(a) as an alternative ground. In the instant case the Commissioner reversed things: he relied on Section 162(a) in the deficiency letter and attempted at the trial to assert Section 482 as an alternative. In the prior case, the Tax Court held it need not decide which section governed, and in the present case it held that Section 162(a)

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4. See footnote 3, *supra*.

5. 23 T.C.M. at 2107. The relevant portions of the opinion are reproduced in Appendix E, *infra*, pp. 67-92.

6. 23 T.C.M. at 2109 (Appendix E, *infra*, p. 75).

contained authority for the intercorporate adjustment. The Tax Court sustained the corporate adjustments described, including rental disallowances for the slot machines for a year subsequent to the years involved in the prior case.

The Tax Court also sustained the duplicating tax against the Graves, even though the constructive dividends it taxed were grossed up; *i.e.*, they included the amounts held payable to the United States by the Challenger as income tax. Because both The Challenger and the Graves were in the highest tax brackets effective in those years (52% and 91%, respectively), the combined tax rate on the same income was 143 per cent. Thus, for each $100.00 of income combined taxes of $143.00 were imposed.

An appeal was taken to the Court of Appeals for the Ninth Circuit, which affirmed in an opinion written by Senior District Judge Byrne. Both courts held the failure of Congress to confer the power in Section 162(a) to confine rental deductions to "reasonable" amounts as it expressly had in the same subsection for salary deductions, was without significance where related taxpayers were involved. The Tax Court did not discuss our contention that Section 482 expressly confers that authority, is the sole statutory implement for the purpose, and here was not employed. It also did not discuss our contention that Section 482 does not authorize either creation of income or duplication of taxes on it but only the "allocation" from one taxpayer to another of "gross income" or "deductions." The Court of Appeals discussed and rejected both contentions, as well as our further contention that the Graves did not have the economic benefit from the payment of rent by one controlled corporation to another necessary to constitute the economic equivalent of real income.

REASONS FOR GRANTING THE WRIT

1. The decision below conflicts with the decision of the Court of Appeals for the Second Circuit in *Rubin* v. *C.I.R.*, (1970) 429 F.2d 650, and in so doing increases the confusion present in the court decisions concerning the proper scope of 1954 Internal Revenue Code Section 482.

Section 482 (Appendix D, *infra*, p. 66) applies exclusively to "two or more organizations (whether or not incorporated . . .) owned and controlled directly or indirectly by the same interests . . .", and it authorizes the Secretary or his delegate to "distribute, apportion, or allocate *gross income, deductions* . . . between or among such organizations. . . ." (Emphasis ours.) In *Rubin* v. *C.I.R., supra,* 429 F.2d 650, the Court of Appeals for the Second Circuit held that Section 482 was the exclusive authority to allocate "gross income" between related businesses, and the Commissioner could not seek to accomplish under Section 61, defining "gross income", what Section 482 gave him authority to do. The court disapproved a reallocation of gross income between two corporations and their controlling shareholder which both the Commissioner and the Tax Court had based on Section 61, and remanded for reconsideration exclusively under Section 482.

In the present case, the Court of Appeals for the Ninth Circuit permitted reallocations of rental deductions between two corporations and their controlling shareholders under Section 162, a deduction section. As noted above, Section 482 specifically applies to allocation of "deductions" as well as "gross income". The court rejected the contention that Section 482 was the exclusive statutory authority for such an adjustment and permitted the reallocation to be made as a disallowance of rent under its construction of Section 162. The court noted the *Rubin* case and refused to follow it, commenting that there was no occasion for the Ninth Circuit joining it in adding "a new wrinkle to the law." (Appendix B, *Infra*, p. 52.)

The two decisions also conflict in their treatment of an asserted constructive dividend to the common shareholder. In *Rubin*, the Tax Court had held that the controlling shareholder had constructive income under Section 61, which includes "dividend" in its definition of gross income (51 T.C. 251), and the Court of Appeals reversed, noting that under Section 482 ameliorative rulings, issued to avoid the type of double taxation asserted both there and here, would be available. This effect of *Rubin* was fully argued below, but the court did not discuss that aspect of *Rubin* while refusing to follow it.

The conclusion that Section 482 applies here is amply supported by the statutory language extracted above and set forth in full in the Appendix, and by Treas. Reg. Sections 1.482-2(e)(1) and (2)(c) (Appendix F, *infra*, p. 93) in which the Secretary has exercised the discretion the statute confers on him. The first cited regulation specifically applies Section 482 to rentals for tangible property between related parties, and the second one states the definition of a proper rental. The Commissioner did not dispute below that Section 482 was applicable but contended it was not exclusive and that he had his choice of proceeding under it, which by his concession would have precluded a constructive dividend to the common shareholder, or under Section 162, which would permit the constructive dividend.[7] The court below allowed him this choice, and the Second Circuit in *Rubin* did not.

A conclusion that the Commissioner can choose to accomplish under other sections what Section 482 specifically

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7. Brief for the Appellee, No. 26,504, United States Court of Appeals for the Ninth Circuit, pp. 23-25; the contention of optional overlap of the two sections and the concession that adjustments under Section 482 would not produce a constructive dividend were explicit in oral argument in response to questions from the bench.

authorizes seems patently wrong. Certainly, it is illogical to believe that Congress enacted Section 482 merely to lengthen the Internal Revenue Code.[8] Moreover, such a view makes sport of the Court's recent carefully considered limitation on Section 482 in *Commissioner* v. *First Security Bank of Utah*, (1972) 405 U.S. 394. If the *Rubin* case is wrong and the decision below is correct, the Commissioner is free to relitigate his *Security Bank* loss in later years by relying on Section 61 instead of Section 482. As a different statute is involved, collateral estoppel will not interfere. Yet, we believe it clear that this Court thought it was doing more than merely deciding an individual case for a particular year when it took that case and decided it.

Because the use of multiple corporations is a standard business practice, the questions presented by this conflict of decision are found in numerous instances and are inherently of large revenue implications.

2. The exclusivity and scope of Section 482 present important questions under the Internal Revenue Code which have not been but should be settled by this Court. The exclusivity question is presented by the conflict between the decision below and *Rubin* v. *Commissioner, supra,* point 1, 429 F.2d 650. The question of scope is presented here by the issue whether duplication of income by creating constructive income at the second tier is proper.

Our view that reliance on Section 482 would preclude the creation of constructive second tier income is fully supported by the heretofore settled rule, only recently challenged, that Section 482 authorizes the allocation of gross income between related entities but not its creation. The leading text states:

> "Section 482 of the 1954 Code is predicated on the existence of income. The courts have uniformly held that there is no authority in the Secretary or his dele-

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8. Section 482 is derived without significant change from Section 45 of the Revenue Act of 1928.

> gate under this provision to charge income to one of the businesses, if, in fact, no income actually exists, or to disallow deductions altogether, and that the only authority is to allocate income or deductions in order clearly to reflect the income of the controlled businesses. Section 482, in contrast to Sections 269 and 1551, does not authorize disallowances; it authorizes only distributions, apportionments, and allocations. Where Section 45 of the 1939 Code has been applied to a related taxpayer, the Court will implement that provision to avoid any duplication by disallowance of deductions." 7 Mertens, *Law of Federal Income Taxation*, p. 176.

That rule is based on the decision in *Tennessee-Arkansas Gravel Co.* v. *Commissioner*, (C.A. 6, 1940) 112 F.2d 508, and cases following it; *viz.*, *Smith-Bridgman & Co.*, (1951) 16 T.C. 287 (Acq. 1951-1 Cum. Bull. 3, limited 1967-1 Cum. Bull. 117), and *Seminole Flavor Co.*, (1945) 4 T.C. 1215 (Acq. 1945 Cum. Bull. 6). It has more recently been followed by the Tax Court in *Huber Homes, Inc.*, (1971) 55 T.C. 598, 607, *PPG Industries, Inc.*, (1970) 55 T.C. 928, and *Kahler Corp.*, (1972) 58 T.C. 496.

Huber Homes, supra, was the first Tax Court decision to reconsider that rule after the promulgation of the present Treasury Regulations, and in a carefully considered opinion by Judge Raum the court adhered to the settled rule. Later, in *B. Forman Co., Inc.* v. *Commissioner*, (C.A. 2, 1972) 453 F.2d 1144, in an appeal from the Tax Court where that court had not had occasion to consider the issue, the appellate court per District Judge Zavatt held that under Section 482 interest income could be imputed to a parent which had made an interest-free loan to a controlled corporation. In *Kahler Corp., supra*, the full Tax Court considered the *Forman* case and refused to follow it, saying:

> "With due respect, we are of the opinion that [it] incorrectly delineated *both* the purpose of Section 482

and the circumstances required before the statute can operate. . . .

. . .

"Section 482 does not punish the mere existence of common control or ownership . . ."

The Tax Court's view that Section 482 is not designed to punish is emphasized by the Revenue Service's own rulings: Rev. Proc. 64-54, 1964-2 Cum. Bull. 1008; Rev. Proc. 65-17, 1965-1 Cum. Bull. 833, amended 1966-2 Cum. Bull. 1211; and Rev. Proc. 65-31, 1965-2 Cum. Bull. 1024. These rulings permit the taxpayers to restore without duplicating tax liability funds reallocated by the Commissioner under Section 482. Rev. Proc. 65-17 even permits dividends paid from funds later reallocated away from the payor to be repaid without tax and the dividends removed from the taxable income of the recipient-repayor. No ruling seeks to cope with the metaphysical gymnastics of constructively repaying a dividend only constructively received, and undoubtedly this lack is because the Revenue Service then recognized that if it makes a reallocation under Section 482 it cannot also create second tier constructive income.[9]

We are informed that following the decision in *Forman*, the Revenue Service designated this issue as a primary litigation issue, and the Commissioner has appealed the *Kahler* case, as well as a companion case, *Kerry Investment Co.*, (1972) 58 T.C. 479.[10] If the Commissioner should here assert that the creation of second tier income is proper under Section 482, this case will present an appropriate vehicle for settling an issue which otherwise will produce a large volume of litigation in the lower courts and probably require ultimate resolution here anyway.

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9. On remand in *Rubin*, neither the Tax Court (56 T.C. 1155) nor the Second Circuit (460 F.2d 1216) departed from this principle. They permitted an allocation to the shareholder of enlarged income from his personal services rendered to a controlled corporation, not a constructive dividend.

10. P-H Federal Taxes Report Bulletin, Nov. 9, 1972, p. 60,694.

At the corporate level, the application of Section 482 should also make a difference. The "allocation" of gross income called for by Section 482 should consider the profit margins of both corporations and not create a 17 per cent rate of return for one and a nearly 50 per cent rate of return for the other, as the Tax Court did here by construing Section 162(a) to limit the rental deduction to a figure which produced a normal parking lot rate of profit for one and increased the rate of profit of the other from 45 per cent to 50 per cent.

Furthermore, the standard of Section 482 is to place controlled corporations in the position of uncontrolled corporations. When the casino was sold outside the controlled group, the parking lot rental remained the same, and has not been questioned or disallowed by the Revenue Service. The situation was thus the converse of that which was held to control the application of Section 482 in *Commissioner* v. *First Security Bank of Utah,* (1972) 405 U.S. 394. Proper consideration of the context of Section 482 might well eliminate any deficiency at the corporate level insofar as the parking lot rents were concerned.

The importance of the questions is difficult to exaggerate. In 1968 the first lengthy, detailed and all-encompassing Treasury Regulations under Section 482 were issued, some three years after they were first proposed and an interlude of hearings and revisions. They are applicable to all open years. They are prolix with examples of intended scope extending to all types of "gross income" and "deductions" possibly involved in intercorporate economic relationships. If the Commissioner has, as was held below, inherent power under Section 162 to disallow rent paid by one affiliate to another so that he need not invoke Section 482, then the same is true of all other business expenses dealt with by Section 162, and of interest (Section 163), losses (Section

165), and other cash items made deductible by some eight sections, as well as of all types of gross income, including income from rents, interest, and from sales of goods and other property. Indeed, it is necessarily true, since the income tax is derived from statutes, that there is some statute in the Code taxing each type of "gross income" and allowing each type of "deduction" to which Section 482 applies, so if the decision below is correct and that in *Rubin* is wrong, it follows that the Commissioner has inherent power derived generally from the Code which completely duplicates Section 482.

The question of scope is likewise important and, as noted above, will produce litigation to settle questions long thought settled as well as the duplication of income issue here presented. Parent corporations have long thought that temporary contributions to the capital of subsidiaries or affiliates in the form of interest-free loans or rent-free leases of equipment were proper and free of adverse tax consequences, so many such situations exist to be litigated until the rules again become settled. This decision and the *Forman* decision have thoroughly confused and unsettled an important area of law and this case is an appropriate vehicle for clarifying the law.

We are not alone in believing that clarification here is necessary, in view of these conflicts. The same view is expressed in Nauheim, *B. Forman & Co., Inc.—A Crucial Test of the Future of Section 482,* 26 The Tax Lawyer (Fall, 1972), pp. 107, 122, 123.

3. The decision below conflicts with *International Business Machines Corp.* v. *United States,* (Ct.Cl. 1965) 343 F.2d 914, and a number of other decisions holding that the Commissioner must apply the tax law equally to taxpayers situated alike. The decision is strangely inconsistent with our basic concept of equal justice under the law. To permit

the Commissioner the choice of applying Section 482 with its judicial and administrative rules designed to prevent penal duplication of taxes, or Section 162 and constructive dividend principles which here produced a cumulative tax of 143 per cent of the disallowed rentals, is necessarily to vest him with power to treat persons similarly situated differently. By what standard is he to choose? We asked the court below if it thought Congress intended to confer on the Commissioner the power to confine the harsh rules to Democrats in Republican administrations, and to Republicans in Democratic administrations. Without expressing itself explicitly, the court necessarily answered the question in the affirmative, which presents a fundamental and important departure from an established principle, and is in direct conflict with *International Business Machines Corp.* v. *United States, supra,* 343 F.2d 914. In that case, a tax which otherwise would have been valid was held refundable where necessary to produce equality between two major competitors.

The principle was stated by Mr. Justice Frankfurter in a concurring opinion in *United States* v. *Kaiser,* (1960) 363 U.S. 299, 308. "The Commissioner cannot tax one and not tax another without some rational basis for the difference." It was applied to sustain a retroactive revocation of an administrative ruling in *Automobile Club of Michigan* v. *Commissioner,* (1957) 353 U.S. 180, 185-186, where that was deemed necessary to place all auto clubs on tax parity. It has been the basis of decision in *Connecticut Ry. and Lighting Co.* v. *United States,* (Ct.Cl., 1956) 142 F. Supp. 907, *Weller* v. *Commissioner,* (C.A. 3, 1959) 270 F.2d 294, and *Exchange Parts Co. v. United States,* (Ct.Cl., 1960) 279 F.2d 251.

The court below treated the principle with disdain, since its only reference to it was the oblique remark that the

court need not join *Rubin* v. *Commissioner, supra,* 429 F.2d 650, which did apply it, in adding "a new wrinkle to the law." The conflict should be settled so that the courts may understand that their obligation to construe the statutes to tax equally situated taxpayers alike is an old and honored one and not "a new wrinkle."

4. Wholly apart from Section 482, the decision below also conflicts in principle with the important decision of the Court of Appeals for the Third Circuit in *Holsey* v. *Commissioner,* (1958) 258 F.2d 865. The *Holsey* case has been accepted as correct since the announcement by the Internal Revenue Service in 1958 that it would follow *Holsey* (Rev. Rul. 58-614, 1958-2 Cum. Bull. 920). The announcement brought litigation in that area to an end and the law was thought to have become settled. The court below did not acknowledge the conflict but attempted to distinguish *Holsey* on grounds which are both incorrect and insubstantial. Unless clarified by this Court, this conflict in principle between the circuits is certain to rekindle the fires of litigation in an important area of income tax law.

Both this case and *Holsey* involve the payment of cash by a corporation to another person or corporation, and the question whether that payment should be taxed as a constructive dividend to a third person, the sole shareholder. In this case, the payment was rent; in *Holsey,* it was payment to another person for his stock. The question in each case was whether the shareholder had sufficient economic benefit from the payment to have it treated as income to him, as a constructive dividend. In each case, the Tax Court held that there was such benefit and sustained the tax. It was reversed in *Holsey* and affirmed here.

The benefit to the shareholder in *Holsey* was clearer than it is here. Holsey had had an option to buy all his fellow shareholder's stock, an he assigned the option to

their corporation, which exercised it. If he was thus able to become sole shareholder without having to become personally taxable on the corporate payments to the other shareholder, he had a tax advantage, but the Court of Appeals held that that was not a personal economic benefit. Nor would it agree with the Tax Court that the acquisition of corporate control without personal income tax was an economic benefit constituting the equivalence of income.

The instant case involves less economic benefit. There is almost always some economic reason for the creation of multiple corporations, and Congress has stated what tax consequences it wishes them to have. In addition to Section 482, Congress has acted to deny them multiple surtax exemptions (Section 1561), to deny them certain tax benefits where their control was acquired principally for tax saving purposes (Section 269), and to provide that the purchase by one affiliate of the stock of a second constitutes a taxable dividend if one would have resulted from the purchase of its own stock by the second (Section 304). Only the last section taxes constructive dividends, and it operates in a carefully defined area, having no bearing here. Here, there were no economic benefits to Graves not attributable to the income tax structure. The test of need for multiple corporate structures is whether one corporation could have sufficed.[11] Had there been but one corporation and no income tax structure, The Challenger would have owned the parking lots, paid the debt service on them, and paid no rent. Similarly it would have owned the slot machines and the casino building owned by The Pub, *et al.*, and would have paid the debt service on the building the slot machine

11. As noted above, in a prior case by decision (*The Challenger, Inc.*, (1964) T.C. Memo. Op. 1964-338, 23 T.C.M. 2096) and in the instant case by concession, the dominant business reason for the use of all the six corporations but one was established.

rentals helped pay. Then, when the Graves wished to sell the stock of The Challenger, they simply would first have had the parking lots and any other property they wished to retain distributed to them in a dividend or in partial liquidation and they could then have sold Ascuaga precisely what they did sell him. Only our income tax structure makes such a solution uneconomic, because of the high taxes it imposes on the distribution of the property to be retained.

Thus, the economic benefit to the Graves is not an economic benefit at all but a tax benefit, just as it was in *Holsey*.[12] In *Holsey* a court of appeals held such a benefit was not sufficient to be a constructive dividend to the controlling shareholder and here a different court of appeals held that it was. The conflict is inescapable.

The importance of the question in times of permanently high income tax rates is that the search for constructive income seems recently to have become a cardinal principle of tax administration. The Graves' constructive income was taxed at 91 per cent, and the same exact amount was also taxed to the corporation at 52 per cent. The combined, penal rate of 143 per cent has obviously removed the tax benefit, and since the tax benefit was the only economic benefit it has also eliminated the economic benefit which was supposed to represent income. This conflict thus presents in clear form the basic issue in the definition of that nonstatutory concept: constructive income.

5. If the income tax statutes are properly interpreted to mean what the lower courts held, they raise two serious constitutional questions.

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12. *Holsey* does not stand alone. See also *Tucker* v. *Commissioner*, (C.A. 8, 1955) 226 F.2d 177, reversing 23 T.C. 115, and *Niederkrome* v. *Commissioner*, (C.A. 9, 1958) 266 F.2d 238, reversing on this issue T.C. Memo. 1956-255, 15 T.C.M. 1312. But it was the decision in *Holsey* which the Commissioner announced he would follow and that announcement is what ended litigation on those facts.

A) The effective combined rate of tax imposed below is 143 per cent, of which 52 per cent is on The Challenger and 91 per cent on the Graves. No deduction from the constructive dividend taxed to the Graves was allowed for the portion of it which the court held should be paid to the Treasury in income tax, so 52 per cent of the constructive dividend was required to be paid in tax at the corporate level and yet was simultaneously taxed to the Graves at 91 per cent.

The statute does not so provide, in any way which would be an intelligible warning to the citizen seeking to comply before the fact. Yet its effect, if affairs are so conducted, is to impose taxes of 143 per cent, which, because the total exceeds the income on which it falls, are penal in amount.

A penalty on conduct not proscribed in terms understandable by "men of common intelligence" is a denial of due process. *Connolly* v. *General Construction Co.*, (1926) 269 U.S. 385, 391. The void for vagueness rule does not apply only to criminal statutes but to civil penal statutes as well. *Cramp* v. *Board of Public Instruction*, (1961) 368 U.S. 278. As this Court stated in *Lanzetta* v. *New Jersey*, (1939) 306 U.S. 451, 453:

> "No one may be required at peril of life, liberty or *property* to speculate as to the meaning of penal statutes. All are entitled to be informed as to what the State commands or forbids." (Emphasis ours.)

There are two respects in which the income tax statutes would conflict with this constitutional principle if they are construed as they were below. First, the statute taxes "dividends" and goes to some pains to define them (Sections 301, 316, *cf.* Section 315) but in no place does it either tax or define "constructive dividends." It refers to and defines "Constructive Ownership of Stock" (Section 318) but not

"constructive income." The implication is that "constructive dividends" are not known and taxed.

Second, Section 162(a) allows the deduction of "rentals" without limiting them to "reasonable" as it does with salaries, and without distinguishing between rentals paid to affiliated corporations and those paid to outsiders. An inquiring reader would find that distinction in Section 482, but would find nothing in the power there conferred to "distribute, apportion, or allocate" suggestive of the power to impose a penalty by imposing cumulative taxes up to 143 per cent, and the court decisions and the present administrative interpretation of Section 482 both abstain from asserting duplication of taxes.

A serious question is presented, if the statute was properly construed below, whether its imposition of cumulative taxes penal in amount is not a denial of due process under the Fifth Amendment because of the failure of the statute to state intelligibly what conduct it will penalize.[13]

B) Construed as it was below, the statute presents serious question whether what it taxes is income in the constitutional sense. In *Eisner* v. *Macomber*, (1920) 252 U.S. 189, a common stock dividend paid to common stockholders was held not to be income subject to unapportioned taxation under the Sixteenth Amendment, and that case and its ruling have remained a cardinal principle of taxation. This Court held that it would be reexamined only under positive command of Congress and absent such command the statutes would not be interpreted to challenge it. *Helvering* v. *Griffiths*, 1943) 318 U.S. 371, 394-404. The decision below can-

13. The principal support cited below for the constructive dividend was not any statute but the decision in *Sammons* v. *United States*, (C.A. 5, 1970) 433 F.2d 728. The court below did not observe that no duplicating tax was asserted in *Sammons*. There was but one tax and it was on Sammons. That was not penal taxation.

not be reconciled with it. The Graves received no distribution, merely the appreciation in the value of their stock in one corporation, which was balanced by the depreciation in value of their stock in the other corporation. As in *Eisner* v. *Macomber* and *Holsey* v. *Commissioner*, both *supra*, the income which the Commissioner sought to tax was still locked up in the corporation, and any effort to withdraw it would produce a *second* tax on them, if there is a first tax now. As those cases recognize, every shareholder is wealthier for his corporation's receipt of net income, but he is not taxable on that account.

The decision below construes the statute to conflict with that principle and raises a serious constitutional issue.

CONCLUSION

For the reasons stated above, the petition for a writ of certiorari should be granted.

Respectfully submitted,

VALENTINE BROOKES
DEREK T. KNUDSEN
Attorneys for Petitioners

December 4, 1972.

Appendix A

T. C. Memo. 1970-74

UNITED STATES TAX COURT

SPARKS NUGGET, INC., ET AL.,[1] Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

(Filed March 31, 1970.)

Memorandum Findings of Fact and Opinion

SIMPSON, Judge: The respondent determined liabilities of the petitioners as follows:

Docket No.	Petitioner	Basis of Liability	Taxable Year Ended	Deficiency
4277-67	Sparks Nugget, Inc. ..	Transferee of The Challenger, Inc.	9/30/59 9/30/60	$ 69,622.34 86,211.78
4277-67	Sparks Development Co.	Income tax deficiency	11/30/61	9,940.29
4278-67	Flora J. Graves	Income tax deficiency	12/31/59	29,083.17
4279-67	R. L. Graves and Flora J. Graves	Income tax deficiency	12/31/60	137,209.56
4280-67	R. L. Graves..	Income tax deficiency	12/31/59	29,083.17

Some of the issues in this case have been settled; those remaining for decision are:

(1) Whether The Challenger, Inc. (Challenger), can deduct, under section 162 of the Internal Revenue Code of 1954,[2] the full amount of payments it made with respect to

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1. Cases of the following petitioners are consolidated herewith: Sparks Development Co., Docket No. 4277-67; Flora J. Graves, Docket No. 4278-67; R. L. Graves and Flora J. Graves, Docket No. 4279-67; and R. L. Graves, Docket No. 4280-67.

2. All statutory references are to the Internal Revenue Code of 1954.

certain lots leased by it from Sparks Development Co. (Sparks Development).

(2) Whether, for purpose of determining the tax liability of R. L. and Flora J. Graves (the Graves), Challenger should be limited to $2.59 per month in rental deductions, under section 162, for payments with respect to each slot machine leased by it from The Pub, Inc., Saratoga Club, Inc., and United Waldorf, Inc.

(3) Whether the portions of the payments with respect to the lots and the slot machines which are not deductible under section 162 constitute dividends taxable to the Graves.

(4) Whether certain payments made by Sparks Development during its taxable year 1961 to Mr. Graves are deductible under section 162 as "a reasonable allowance for salaries or other compensation."

Findings of Fact

Some of the facts have been stipulated, and those facts are so found.

Sparks Nugget, Inc., is a Nevada corporation which had its principal place of business in Sparks, Nevada, at the time its petition was filed in this case. Sparks Development, also a Nevada corporation, had its principal office in Sparks, Nevada, at the time its petition was filed in this case. For its taxable year ending November 30, 1961, Sparks Development filed its Federal income tax return, using the accrual method of accounting, with the district director of internal revenue, Reno, Nevada. The Graves are husband and wife, who maintained their legal residence in Carson City, Nevada, at the time their petitions were filed in this case. They filed their 1959 individual and 1960 joint Federal income tax returns, using the cash receipts and disbursements method of accounting, with the district director of internal revenue, Reno, Nevada.

Sparks Nugget, Inc., was incorporated on September 29, 1960. Until June 26, 1961, all of the outstanding stock of the corporation was owned by John J. Ascuaga and his wife, Rose. After such date, the Ascuagas owned 98.8 percent of the outstanding stock, and the Graves owned the remaining 1.2 percent. Mr. Ascuaga has been the principal executive officer of Sparks Nugget, Inc., since its incorporation. On September 30, 1960, Sparks Nugget, Inc., purchased all of the outstanding stock of Challenger from the Graves. Thereafter, on June 30, 1961, pursuant to a plan of complete liquidation, Challenger dissolved and all of its assets were distributed in complete liquidation to Sparks Nugget, Inc. Prior to September 30, 1960, at all times relevant hereto, the Graves owned all of the outstanding stock of Challenger. During such years, Mr. Graves was the principal executive officer of Challenger. From September 30, 1960, to June 30, 1961, Mr. Ascuaga was the principal executive officer of Challenger.

Mr. Graves proposed the sale of the Challenger stock to Mr. Ascuaga. Mr. Ascuaga accepted the terms of the proposal without substantial change. The purchase price of the Challenger stock was set at $3,700,000; annual payments in respect of such price were set at the greater of $300,000 or 4.57 percent of Challenger's gross receipts. Sparks Nugget, Inc., agreed that, until the purchase price was paid in full, it would not incur yearly capital expenditures of more than $10,000, without the permission of the Graves. The purchase agreement provided that Mr. Graves would act as a consultant to Sparks Nugget, Inc., for a period of 2 years for an annual compensation of $25,000. Sparks Nugget, Inc., made the final payment in respect of the stock purchase in September 1967.

Sparks Development was incorporated on July 31, 1957. Its outstanding stock has always been wholly owned by the Graves; Mr. Graves has always been its principal executive officer.

The Pub, Inc. (Pub), Caldwell Sports Shop, Inc. (Caldwell), United Waldorf, Inc. (Waldorf), and Saratoga Club, Inc. (Saratoga), are dissolved Idaho corporations. They were organized in 1947 and at all times relevant hereto, prior to May 31, 1963, were wholly owned by the Graves. During such period, Mr. Graves was the principal executive officer of each corporation. On May 31, 1963, the Graves sold all their stock in the corporations to First National Bank of Nevada, as trustee of certain trusts established by the Graves for their children. On December 31, 1963, all of the corporations were completely dissolved and liquidated by the trustee.

I. Rental of Parking Lots

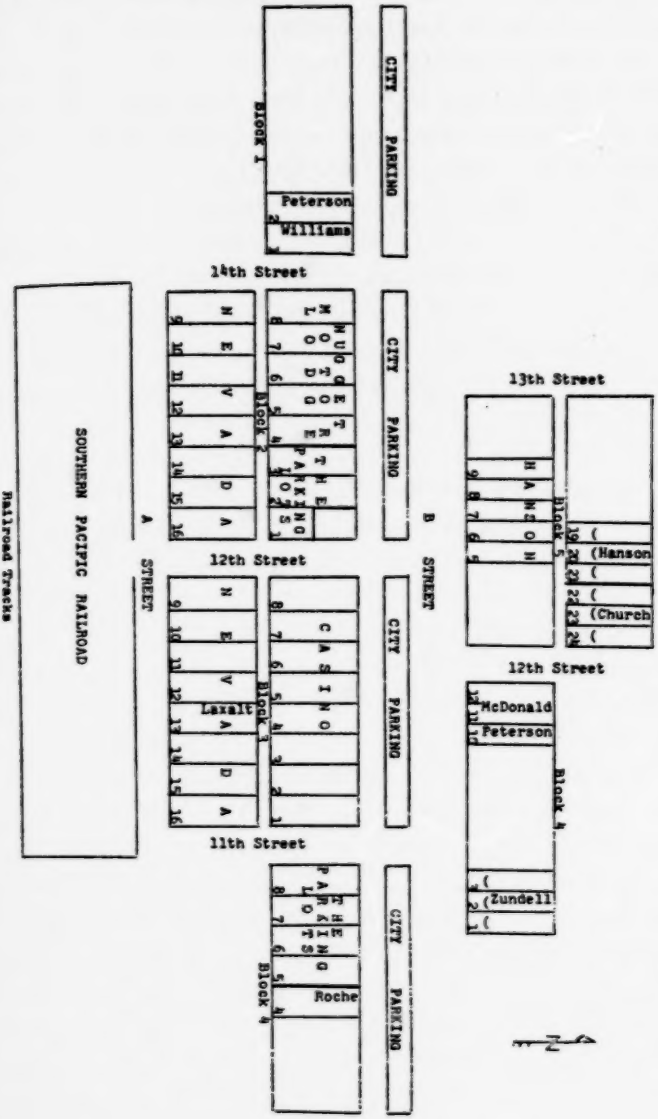
On June 17, 1959, Sparks Development leased 6½ lots located in Sparks, Nevada, to Challenger. Challenger used the lots as parking lots in connection with a gambling casino operated by it known as the Sparks Nugget Casino. Such lots are hereinafter referred to as the Parking Lots.

Practically all of the customers of the Sparks Nugget Casino travel there by car, and the availability of ample free parking has been a substantial factor, contributing toward the casino's success. There is some free on-street parking available in the area of the casino, but such space is insufficient to accommodate all of the casino's patrons.

The Parking Lots had originally been acquired by Mr. Graves as follows:

Lot	Purchase Date	Purchase Price	Square Feet
Blk. 2			
S. 65′ Lot 1	10/20/58	$ 20,072.35	3,250
Blk. 5 Lot 2	11/24/58	32,170.22	7,000
Blk. 2 Lot 3	4/27/59	41,950.77	7,000
Blk. 4 Lot 5	2/28/59	35,570.41	7,000
Blk. 4 Lot 6	4/23/59	40,350.71	7,000
Blk. 4 Lot 7	1/ 6/59	40,485.25	7,000
Blk. 4 Lot 8	7/23/58	43,009.33	7,000
		$253,609.04	45,250

The location of the Parking Lots is shown below on a plan of a portion of Sparks, Nevada.



On June 3, 1959, Mr. Graves transferred title to the Parking Lots to Sparks Development for cash, an assumption of liabilities, and a note, aggregating in value $253,253.05, and for additional Sparks Development common stock with a par value of $20,000.00. On June 3, 1959, immediately after acquiring title to the Parking Lots, Sparks Development borrowed $150,000 from the Nevada Bank of Commerce on two notes, each bearing 6-percent interest, one being in the amount of $115,000 secured by a first deed of trust on Lots 2 and 3 of Block 2 and Lots 5, 6, and 7 of Block 4, and the other an unsecured note for $35,000.

Mr. Graves negotiated the lease of the Parking Lots (sometimes hereinafter referred to as the Parking Lot Lease) on behalf of both Challenger and Sparks Development. Mr. Ascuaga took no part in such negotiation. Mr. Graves fixed the lease rental on the basis of the amount of income that Sparks Development would need to pay his compensation, its income taxes, and its purchase obligations on the Parking Lots. He prepared a pro forma income and expenditures statement which, together with the proposed lease, he took to the Nevada Bank of Commerce. On the basis thereof, the bank agreed to make the purchase money loans necessary for Sparks Development to acquire the Parking Lots.

The Parking Lot Lease, executed on June 17, 1959, leased the Parking Lots to Challenger for a term of 5 years commencing June 17, 1959, for the following rental: $9,400 per month for the first year of the lease term and $8,000 per month for the following 4 years of the lease term. The larger rental in the first year of the lease term was provided because of the higher loan payments required of Sparks Development during such period. Under the terms of the lease, Challenger was required to keep the premises in good repair, to pay for all utilities used on the premises, to keep

the property free of any mechanics' or other liens, to hold Sparks Development harmless from any suits or claims arising out of the operation of the property, to maintain public liability insurance of not less than $100,000 for injury to one person and not less than $300,000 for injury to more than one person, and to pay all real estate taxes on the premises. The lease provided that upon the expiration of the initial term, Challenger could continue to rent the Parking Lots for an additional 5-year term upon the terms and conditions contained in the lease, except that the rental would be renegotiated. If the parties could not agree on the rental, the matter would be submitted to arbitration. In the event the business of gambling was outlawed on the demised premises, Challenger was given the right to terminate the lease upon the payment of an amount equal to 4 months' rent as liquidated damages.

The cost of removal of houses and other improvements on the Parking Lots and the cost of surfacing and marking the lots was borne by Challenger. The lots furnished approximately 143 car spaces.

On September 30, 1960, Sparks Development modified the Parking Lot Lease by providing that Challenger was granted an option to extend the lease term for an additional period commencing with the expiration of the last renewal term and terminating on September 23, 1987. This extension was made at the insistence of Mr. Ascuaga in connection with the purchase of the Challenger stock by Sparks Nugget, Inc. The renewal was to be upon the same terms and conditions contained in the Parking Lot Lease, except for the rental, which was to be renegotiated each 5 years. In the event of disagreement as to the monthly rental, the matter would be submitted to arbitration in the same manner provided in the Parking Lot Lease.

The Parking Lot Lease was renewed in accordance with its terms after the expiration of the initial term in 1964. The rental for the renewal term was not renegotiated and remained at $8,000 per month.

Pursuant to the terms of the Parking Lot Lease, Challenger accrued and paid to Sparks Development $37,000 in its taxable year ended September 30, 1959, and $107,200 in its taxable year ended September 30, 1960. The respondent determined that to the extent the monthly payments exceeded $4,000 they "were not required to be made for the use of" the Parking Lots in Challenger's business. Under this computation, Challenger's deductions were reduced to $16,000 for 1959 and $48,000 for 1960.

The following information pertaining to other real estate transactions involving the petitioners relates to the question of the reasonable rental of the Parking Lots. The references to Block and Lots numbers correspond to the plan of Sparks set forth previously.

A. The McDonald Premises

On September 25, 1954, Challenger leased the McDonald premises for a term of 10 years, with a 10-year renewal option, at a monthly rental of $700. The premises consist of Lots 11 and 12 in Block 4 on the north side of B Street and contain approximately 7,000 square feet. On the premises, Challenger opened on March 17, 1955, a bar, restaurant, and casino known as the Sparks Nugget.

B. The Peterson Premises

On April 27, 1955, Challenger leased the Peterson premises for a term of 3 years, with a 7-year renewal option, at a monthly rental of $500, and a further 10-year renewal option at a monthly rental of $700. The premises consist of Lot 10 in Block 4 on the north side of B Street and

contain approximately 3,500 square feet. The premises were used for an expansion of the Sparks Nugget operation.

C. The Zundell Premises

On November 21, 1955, Mr. Graves leased the Zundell premises effective January 1, 1956, for a term of 5 years with a 5-year renewal option, at a monthly rental of $700, and a further 10-year renewal option at a rental to be negotiated. The premises consist of Lots 1, 2, and 3 in Block 4 on the north side of B Street and contain approximately 10,500 square feet. On May 28, 1956, Mr. Graves assigned the lease to Challenger. The premises in part were used for an expansion of the Sparks Nugget operation.

D. The Sparks Nugget Casino Premises

On May 1, 1957, Mr. Graves created four irrevocable trusts, each with a corpus of $6,000, one trust for each of his children. The First National Bank of Nevada (hereinafter referred to as the Trustee) was made trustee and given power to commingle the funds of the different trusts. On the same day, the four trusts formed a joint venture called the Graves Children Trust No. 1. The joint venture bought eight lots, Lots 1-8 in Block 3, for a total of $180,134.05. The bank took a mortgage of $153,000 on the property. The eight lots were located across B Street from the then location of the Sparks Nugget Casino which had opened in March 1955.

On May 1, 1957, the Trustee leased the eight lots to Challenger for a 10-year term for use as a parking lot. The rent was fixed at $2,500 per month for the first year and was then to be renegotiated but not to exceed $2,750 per month. The premises contain approximately 56,000 square feet. At the time of the Trustee's purchase of the premises, there were situated upon all or part thereof houses and

related improvements, which were removed at the expense of Challenger. Challenger also bore the expense of improving the premises thereafter for automobile parking. Challenger was obligated to pay in respect of the premises all taxes and assessments, insurance, utilities, and all other maintenance and operating expenses.

On August 29, 1957, Pub., Caldwell, Waldorf, and Saratoga formed a joint venture known as Nugget Enterprises, for the purpose of leasing the eight lots, constructing a casino building thereon, and subleasing it to Challenger. The joint venturers agreed to share the profits and losses equally.

On September 23, 1957, the lease of May 1, 1957, between the Trustee and Challenger was cancelled by agreement of the parties thereto. A new lease of the same premises was entered into on the same date between the Trustee and Nugget Enterprises for 20 years at $3,750 per month for the first 5 years. The rent was to be renegotiated each 5 years. Nugget Enterprises had an option to renew for an additional 10 years. The property was to be used for a gambling casino, restaurant, and related facilities. Nugget Enterprises was obligated to pay in respect of the premises all taxes and assessments, insurance, utilities, and all other maintenance and operating expenses.

By an agreement dated the same day, September 23, 1957, Nugget Enterprises subleased the same premises to Challenger for 10 years (with an option in Challenger to renew for another 10 years) at $3,750 per month for the first 7 months and $15,000 per month thereafter. On September 30, 1960, the sublease was extended in a manner similar to the extension of the Parking Lot Lease. Challenger was obligated to pay, in respect of the premises, all taxes and assessments, insurance, utilities, and all other maintenance and operating expenses. In accordance with

the terms of the sublease, Nugget Enterprises constructed a new casino building on Lots 4, 5, 6, and 37 feet of Lot 7 in Block 3 of the premises. The building was completed on May 12, 1958, at a total cost, as of the end of 1958, of $796,769.81. Lots 1, 2, 3, 8, and 13 feet of Lot 7, continued to be used for casino parking.

On May 12, 1958, the Sparks Nugget operation was moved from the McDonald and Peterson premises to the new casino. On May 26, 1958, Challenger assigned the McDonald and Peterson leases to Trader Dick's Inc., a Nevada corporation owned and controlled by Mr. Graves, for use as a restaurant.

On November 1, 1959, Nugget Enterprises completed an enlargement of a boiler room in the casino at a cost of $31,933.65. On January 4, 1960, at a meeting of the board of directors of Challenger, Mr. Graves indicated that the new boiler room was necessary for safety reasons and that a new addition to house a pancake restaurant was desirable. He stated that he estimated the cost of these additions to be $150,000, and that Nugget Enterprises would furnish them if the rental were increased from $15,000 a month to $16,500 a month. The board of directors adopted a resolution approving the improvement and agreeing to the rental increase. On April 1, 1960, Nugget Enterprises enlarged the casino by the addition of a restaurant called the Pancake Parlor at a cost of $88,588.32. The boiler room and pancake restaurant improvements occupied Lot 8 and the remaining 13 feet of Lot 7. Effective March 1, 1960, the rental paid by Challenger to Nugget Enterprises was raised to $16,500 a month.

On July 1, 1962, Nugget Enterprises completed a theatre-restaurant and related facilities on Lots 1, 2, and 3 in Block 3 at a cost of $1,650,895.45. The related facilities apparently included 104 small hotel-roomettes available to the public for hire, which were opened in September 1962.

Mr. Graves conceived the idea of the theatre-restaurant and was planning it in September 1960. On July 21, 1961, Nugget Enterprises, by Mr. Graves, proposed to the Trustee the construction of the theatre-restaurant on its land and requested that the Trustee give its formal approval to construction. In consideration of such approval, Nugget Enterprises suggested that the monthly rental on the ground lease be increased to $6,000 a month. The proposal was acceptable to the Trustee, and commencing on January 1, 1962, the monthly rental on the ground lease of the casino premises between Nugget Enterprises and the Trustee was increased to $6,000.

The construction of the theatre-restaurant commenced in the middle of 1961, and it opened in July 1962. The new boiler room, pancake restaurant, and theatre-restaurant additions nearly doubled the size of the casino building, and utilized areas that previously were used for automobile parking. The opening of the theatre-restaurant increased the need for parking, particularly because of large crowds at show times.

In connection with the construction of the theatre-restaurant, the Trustee acquired a 6-foot strip of adjoining land (6′ x 140′) from the City of Sparks by trade for a similar 6-foot strip of Lot 8 in Block 4 owned by Sparks Development. Although the 6-foot strip, which was traded to the City of Sparks, was owned by Sparks Development and was leased by Challenger under the Parking Lot Lease, there was no reduction in the rental paid by Challenger to Sparks Development for the loss of the 6-foot strip, nor was any effort made to secure such a reduction.

On January 1, 1962, the rental paid by Sparks Nugget, Inc., to Nugget Enterprises for the eight lots was raised to $24,000 a month, and on July 1, 1962, the rental was raised to $55,708.77 a month, pursuant to the terms of an agreement dated November 14, 1961.

E. The Hanson Premises

On December 12, 1958, Sparks Development leased eight half lots from Frank E. and Rose Hanson for $1,000 a month for a term of 5 years with an option to renew for 5 years on the same terms, and a further option to renew for 10 years at a rental to be negotiated. The half lots are Lots 5, 6, 7, 8, 9, 19, 20, and 21 in Block 5; each is 25 feet wide and 140 feet deep. A brick market building was situated on half lots 5, 6, and 7. From time to time, Sparks Development rented out the building for various uses at $700 a month. The Hanson premises contain 28,000 square feet, of which 17,500 square feet is available for parking. On December 12, 1958, Sparks Development subleased half lots 8, 9, 19, 20, and 21 to Challenger for $1,000 a month for automobile parking purposes. In 1963, Sparks Development renewed the Hanson lease on the same terms, and in 1965, Sparks Nugget, Inc., reconstructed the Hanson building into a convention center.

F. The Southern Pacific Railroad Premises

On May 15, 1958, Challenger leased vacant unimproved property for parking purposes from the Southern Pacific Railroad at a rental of $100 a month. The lease was terminable by either party on 30 days' notice. The property is 190 feet deep and 508 feet wide, and is located on the south side of A Street between 11th and 12th Streets. Parking improvements were made at Challenger's expense. Challenger was obligated to pay in respect of the premises all taxes and assessments, utilities, and all other maintenance and operating expenses.

In April 1962, a new lease was entered into between Sparks Nugget, Inc., and the Southern Pacific Railroad for a term of 5 years at a rental of $290 a month. The lease was terminable by the lessor on 30 days' notice if the property was needed, in the lessor's judgment, for industrial, railroad, or highway purposes. The property

included the property previously leased and additional property located south of A Street lying to the west of the property previously leased. The total property leased under this new lease is 190 feet deep and 908 feet wide, being 172,520 square feet. The property was used for automobile parking purposes and all parking improvements thereon were made at the expense of Sparks Nugget, Inc. Sparks Nugget, Inc., was obligated to pay in respect of the premises all taxes and assessments, utilities, and all other maintenance and operating expenses. Further, in the event that assessments for public improvements were made, the lease provided that the rental should be increased by 6 percent of the amount of the assessment per annum.

In December 1963, Sparks Nugget, Inc., and Southern Pacific Railroad made a revised lease of the premises for a term of 5 years with a 5-year renewal option. Challenger or Sparks Nugget, Inc., has continually occupied the Southern Pacific Railroad premises since the May 1958 lease. The premises were originally used only for employee parking, but after the need for parking grew, it was also used by casino customers.

G. The Laxalt Premises

In December 1958, Mr. Graves sold Lot 13 in Block 3 to Paul D. Laxalt, custodian for Mr. Graves' children under the Nevada Uniform Custodian Act, for the sum of $20,000. In August 1959, the custodian leased the lot, containing 7,000 square feet, to Challenger. The lease was for a term of 5 years at $300 a month, with an option to renew for 5 years at a negotiated rent. The cost of removal of the house and related improvements previously situated on the lot and the parking lot improvements were borne by Challenger. On September 30, 1960, the term of the lease was extended in a manner similar to the extension of the Parking Lot Lease. Challenger acquired use of the lot principally for pedestrian access from the casino to the South-

ern Pacific Railroad premises, but the lot was also used for automobile parking. In 1964, the lease was renewed at the same rental, at which time the property was still used for the same purposes. Mr. Graves fixed the rental on the basis of his estimate of the fair rental value of the property.

H. The Nugget Motor Lodge Premises

Mr. Graves purchased Lots 4 through 8 in Block 2 on the dates and for the amounts as follows:

Lot	Purchase Date	Purchase Price	Square Feet
4	3/30/59	$ 42,140.96	7,000
5	4/28/59	50,250.56	7,000
6	6/11/59	42,327.25	7,000
7	6 /8/59	42,344.91	7,000
8	6/ 3/59	42,135.94	7,000
		$219,199.62	35,000

The total purchase price was advanced to Mr. Graves by Challenger. In February 1960, Mr. Graves transferred the lots to Challenger in cancellation of that advance, and at about the same time, Challenger conveyed the lots to Nugget Motor Lodge, Inc., a Nevada corporation, in exchange for 2,500 shares of its authorized capital stock of 5,000 shares. The Lodge, which has 140 rooms, was conceived by Mr. Graves and was opened in 1960. The Lodge building does not occupy the entire 5 lots; there is parking beneath the building and on the balance of the lots.

I. The Williams, Peterson, Roche, and Church Premises

Sparks Development purchased 3 full lots and 3 half lots in 1960 and 1962 as follows:

Lot	Seller	Purchase Date	Purchase Price	Square Feet
Blk. 1 Lot 1	Williams	4/13/62	$ 53,009	7,000
Blk. 1 Lot 2	Peterson	7/15/60	35,625	7,000
Blk. 4 Lot 4	Roche	10/29/62	52,961	7,000
Blk. 5 Lots 22, 23, 24	Church	9/ 5/62	33,049	10,500
			$174,644	31,500

On August 1, 1962, Sparks Development and Sparks Nugget, Inc., entered into a supplemental lease of the Williams, Peterson, Roche, and Church lots. Such lease was for a term ending with that of the Parking Lot Lease. The rental to be charged Sparks Nugget, Inc., was $4,410 a month.

J. The State of Nevada Premises

On April 1, 1964, the State of Nevada leased to Sparks Nugget, Inc., Lots 9 through 16, except Lot 13 (the Laxalt premises), of Block 3, for use as a parking lot. Such lease was on a month-to-month basis at a rental of $600 per month for the first 22 months and $700 per month thereafter. The premises contained 49,000 square feet. Sparks Nugget, Inc., was obligated to pay all utilities and to keep the premises in good condition.

After construction of an elevated viaduct on the premises, the State, in December 1967, made a new lease of the premises, including Lot 13, to Sparks Nugget, Inc., on a month-to-month basis at a rental of $700 a month. The new lease related to premises containing 56,000 square feet. The lessee's use of the premises and obligations were the same as under the first lease.

In June 1968, Sparks Nugget, Inc., completed negotiations of a new lease with the State, covering Lots 9 through 16 in both Blocks 2 and 3 (112,000 square feet), for a term of 20 years at an annual rental of $27,500 for the first 5 years. Sparks Nugget, Inc., is obligated to pay taxes and to make all improvements at its own expense. The lease contemplates that the premises will be used for automobile parking, being divided into approximately 312 car spaces.

At all times material in this case, neither Challenger, Sparks Development, Pub, Caldwell, Waldorf, nor Saratoga ever paid any dividends to the Graves. Although Mr. Graves recognized that no corporate tax benefit could be obtained by having Sparks Development lease the Parking Lots

to Challenger, he felt that such an arrangement could affect the amount of his personal income tax. At the time of the execution of the Parking Lot Lease, Mr. Graves had in mind retiring early from active participation in Challenger's business, and the arrangement concerning the Parking Lots facilitated his sale of Challenger stock, and financially benefited him after such sale.

The reasonable rental of the Parking Lots during 1959 and 1960 did not exceed $4,000 per month.

II. *Rental of Slot Machines*

On March 17, 1955, Pub, Saratoga, and Waldorf leased 100 slot machines to Challenger. Such lease continued in effect with terms unchanged until October 1, 1960, when the machines were sold to Challenger by the lessors for $200 per machine. On its Federal income tax returns, Challenger deducted as slot machine rentals $97,336.07 for its taxable year ending September 30, 1959, and $103,821.15 for its taxable year ending September 30, 1960. The respondent does not dispute that such amounts were actually paid by Challenger to the lessors. However, he has determined that Challenger was not required to pay monthly rent exceeding $2.59 per machine. Accordingly, he has reduced the annual rent deductible by Challenger to $3,108 for both of its taxable years, 1959 and 1960.

In *The Challenger, Inc.* [Dec. 27,198(M)], 23 T. C. M. 2096, 33 P.-H. Memo. T. C. par. 64,338 (1964), we held that a reasonable monthly rent for the slot machines here in issue did not exceed $2.59 per machine for the taxable years of Challenger 1955 through 1958, and to the extent the claimed deductions exceeded such figure, they did not represent amounts required to be paid for the use of the slot machines in Challenger's business and were not deductible.

III. *Payments by Sparks Development to Mr. Graves*

In its taxable year ending November 30, 1961, Sparks Development paid Mr. Graves $8,539.01, which it treated as compensation for services. As in other years, the payment was computed on the basis of 10 percent of the profits of Sparks Development. During the taxable year, Mr. Graves was the president, manager, and sole employee of Sparks Development. Although in prior years, Mr. Graves performed extensive services for Sparks Development in connection with its real estate transactions, during the taxable year his only service to the corporation was his negotiation for the acquisition of the Roche property, which was purchased by Sparks Development on October 29, 1962. Reasonable compensation for Mr. Graves' services during the taxable year was not less than $8,539.01.

Opinion

The respondent's determinations are predicated on three basic arguments. First, he contends that part of the amounts paid by Challenger under the Parking Lot Lease were excessive and not deductible, and that Sparks Nugget, Inc., is liable as the transferee of Challenger for the resulting deficiencies. Secondly, he asserts that the Graves received constructive dividends when Challenger paid to Pub, Saratoga, and Waldorf excessive rentals for the use of certain slot machines and when Challenger paid to Sparks Development excessive rentals for the use of the Parking Lots. Thirdly, he argues that Sparks Development may not deduct, as compensation, certain amounts it paid to Mr. Graves. At the trial, the respondent adopted the alternative position that section 482 is applicable; however, as a result of our decisions with respect to the other issues, we do not reach that issue.

I. *Rental of Parking Lots*

Section 162(a) provides in part as follows:

> (a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—
>
> (1) a reasonable allowance for salaries or other compensation for personal services actually rendered;
>
> • • •
>
> (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

The petitioners point out that section 162(a)(3) does not expressly limit the deduction for rent to reasonable amounts, whereas section 162(a)(1) does limit deductions for salaries or other compensation to reasonable amounts. They contend that if Congress wished to limit rental deductions in the same manner as deductions for compensation, it could easily have done so. According to this argument, the absence of such a limitation reflects the congressional intent that rental deductions should be allowed in toto for all payments made for the purpose of renting property. The petitioners assert that the payments claimed as deductions by Challenger were paid pursuant to a written lease; that the lease required such payments to be made; that Challenger occupied the Parking Lots pursuant to the lease; and that Sparks Development was the sole owner of the Parking Lots. They conclude that whether the payments made with respect to the Parking Lot Lease were reasonable or unreasonable, they are properly deductible as a business expense under section 162. Although the petitioners argue for their position strongly and eloquently, we do not agree.

The authorities have differed over the significance of the lack of an express reasonable limitation on the deductibility of rentals under section 162(a)(3). Section 162 limits all deductions for business expenses to those which are "ordinary and necessary." It has been frequently asserted that business expenses which are unreasonable in amount are not ordinary and necessary and therefore not deductible. Sec. 1.212-1(d), Income Tax Regs.; *Brown Printing Co. v. Commissioner,* 255 F. 2d 436 (C. A. 5, 1958), revg. a Memorandum Opinion of this Court; *Commissioner v. Lincoln Electric Co.,* 176 F. 2d 815 (C. A. 6, 1949), revg. a Memorandum Opinion of this Court, cert. denied 338 U. S. 949 (1950); *Limericks, Inc. v. Commissioner,* 165 F. 2d 483 (C. A. 5, 1948), affg. 7 T. C. 1129 (1946); *I. T.* 3581, 1942-2 *C. B.* 88. Other cases have indicated that, when parties to a lease are unrelated or are otherwise shown to have been dealing at arm's length, rental deductions must be allowed in full with no inquiry into the reasonableness of the amount. *Potter Electric Signal and Manufacturing Co. v. Commissioner,* 286 F. 2d 200 (C. A. 8, 1961), affg. a Memorandum Opinion of this Court; *Utter-McKinley Mortuaries v. Commissioner,* 225 F. 2d 870 (C. A. 9, 1955), affg. a Memorandum Opinion of this Court; *Anderson Dairy, Inc.,* 39 T. C. 1027 (1963); *Coe Laboratories, Inc.,* 34 T. C. 549 (1960); *J. J. Kirk, Inc.,* 34 T. C. 130 (1960) affd. 289 F. 2d 935 (C. A. 9, 1961); *Jos. N. Neel Co.,* 22 T. C. 1083 (1954); *Roland P. Place,* 17 T.C. 199 (1951), affd. per curiam, 199 F. 2d 373 (C. A. 6, 1952), cert. denied 344 U. S. 927 (1953); *Stanwick's, Inc.,* 15 T. C. 556 (1950), affd., 190 F. 2d 84 (C. A. 4, 1951).

In view of the circumstances surrounding the making of the Parking Lot Lease, it is not necessary for us to choose between these conflicting authorities. If the parties to a lease are closely related and if the transaction has not been

negotiated at arm's length, the courts have consistently held that payments in excess of reasonable rent are not "required to be made" and are therefore not deductible under section 162(a)(3). *Potter Electric Signal and Manufacturing Co. v. Commissioner, supra; Utter-McKinley Mortuaries v. Commissioner, supra; Coe Laboratories, Inc., supra; J. J. Kirk, Inc., supra; Jos. N. Neel Co., supra; Roland P. Place, supra; Stanwick's Inc., supra.* The Graves were the sole stockholders of both Challenger and Sparks Development. Mr. Graves was the principal executive officer of both corporations and whatever negotiations between such corporations took place were between Mr. Graves and himself. The evidence indicates that the amount of the rental provided in the Parking Lot Lease was not calculated to reflect the actual value of such lease, but rather, was established with the dual purpose of building up the capital of Sparks Development and providing it with sufficient funds to meet obligations it incurred in connection with the purchase of the Parking Lots. For these reasons, it is clear that the Parking Lot Lease was negotiated between closely related parties not dealing at arm's length. See *Midland Ford Tractor Company v. Commissioner,* 277 F. 2d 111 (C. A. 8, 1960), affg. a Memorandum Opinion of this Court, cert. denied 364 U. S. 881 (1960). Accordingly, if the so-called rental payments are excessive and unreasonable, the excess is not deductible under section 162(a)(3). Such amount is not deductible, irrespective of why it was paid (*Utter-McKinley Mortuaries v. Commissioner, supra*), although the reasons for the payment of the excess are considered later in connection with the question of whether the Graves received any constructive dividends.

The question now becomes whether the rental provided by the Parking Lot Lease was reasonable. The evidence bearing on the reasonableness of the rentals charged chal-

lenger under the Parking Lot Lease has come from three principal sources. Extensive data has been supplied by way of stipulation as to various real estate transactions occurring in the period 1954 through 1968. Additionally, the petitioners called as their witness Mr. Paul A. Walters, who operates a chain of commercial parking lots in Reno Nevada. Finally, the respondent called as his witness Mr. Arthur W. Reber, a professional appraiser who prepared an appraisal of the fair rental value of the Parking Lots. Most of the argument has centered about the validity of this appraisal.

Mr Reber concluded that the fair rental value of the Parking Lot under the Parking Lot Lease was $36,681 a year, or 81 cents per square foot per year. He reached his conclusion by first determining the fair market value of the Parking Lots at the time of execution of the lease by an analysis of sales of real estate located in the vicinity of the Parking Lots occurring between 1955 and 1964. From this data he concluded that the fair market value of the Parking Lots at the time of the lease was $282,163.00 or $6.24 per square foot. To determine the fair rate of return, he analyzed comparable leases of real property and found that the average rental provided in such leases was approximately 10 percent of the value of the leased premises. To this figure, he added three percent to cover the anticipated increase in the value of the Parking Lots over the term of the lease, so that in his opinion, 13 percent was a fair rate of return during the term of the lease. Although the respondent allowed an annual rental of $48,000.00, or $1.06 per square foot per year, he does not seek to increase the deficiency as a result of Mr. Reber's conclusion.

The petitioners vigorously attack Mr. Reber's appraisal on numerous grounds:

A. *Qualifications of Mr. Reber*

The petitioners contended that the Reber appraisal is initially suspect and can in no event be accorded much weight, since Mr. Reber has no extensive experience in appraising Nevada gambling and parking properties. Mr. Reber is an experienced appraiser whose abilities have been noted by this Court in the past. *Norman Baker Smith,* 51 T. C. 429 (1968). He has appraised numerous properties in the State of Nevada, including at least one gambling establishment. He has also appraised numerous commercial properties including parking lots. He testified that he was qualified to make an expert appraisal of the Parking Lots, and we believe him to be so qualified. However, the fact of his qualification does not prove the correctness of his appraisal, and we must now consider the petitioners' substantive objections to that appraisal.

B. *Special Value of Parking Lots to Challenger*

The petitioners argue that the Reber appraisal gave no consideration to the unique value of the Parking Lots to Challenger. They contend that without ample free parking, the Sparks Nugget Casino could not have achieved its great success, and that accordingly, the Parking Lots were far more valuable than $282,163. In addition, they assert that by leasing the Parking Lots, Challenger foreclosed the possibility of the establishment of a competing casino on those premises.

We recognize that free parking was a material factor in the casino's success; but it appears that the Reber appraisal has given this factor adequate consideration. Mr. Reber's appraisal took account of the purchase of the Parking Lots by Mr. Graves during the period July 1958 through April 1959, for a total purchase price of $253,609.04. Yet, Mr. Reber appraised their value as of June

1959, just 2 months after the last acquisition, as $282,163.00, $28,553.96 more than was paid for them. It may be assumed that the sellers of the Parking Lots were aware, at least in general terms, of Mr. Graves' plans and bargained for all that they could get for their properties. In addition, Mr. Reber's analysis took into consideration the sales to Mr. Graves of other properties in the vicinity of the casino, and the prices of these properties must have reflected the bargaining of sellers who were attempting to secure from him the highest possible prices for their properties. Thus, Mr. Reber's determination of the fair market value of the Parking Lots was based upon the prices paid in the market place for properties used in connection with the casino's operations and therefore adequately reflects the value of the Parking Lots to Challenger.

It also appears to us that Mr. Reber's valuation gives sufficient effect to the possibility of eliminating competition, since such valuation is based upon the market price of properties in that vicinity at that time. In addition, we imagine that any number of lots in and around Sparks could have provided a site for competition, and it hardly seems practicable that the Graves could have eliminated all potential competition in the Sparks vicinity by acquiring or leasing all such lots. Furthermore, the petitioners have not shown that competition would reduce the profitability of the casino. The economic success of gambling establishments in such areas as Las Vegas and Reno may well be in substantial part due to the numerous casinos in those areas, which may serve to draw more people to each of them than would be drawn to a single casino in the same location.

C. *Validity of Comparable Sales*

The Reber appraisal states that it arrives at the fair market value of the Parking Lots by the market data or

comparable sales approach. The petitioners note that certain of the comparable sales used by Mr. Reber were sales of the Parking Lots themselves to Mr. Graves. Accordingly, they argue that Mr. Reber's appraisal actually combines the comparable sale and the actual cost approach and that such a mixture renders his conclusions valueless.

Whether or not Mr. Reber technically adhered to the comparable sales approach, we perceive no reason, and none has been advanced, why the use of the actual cost of the Parking Lots diminishes the efficacy of the Reber appraisal. See *International Paper Company v. United States,* 227 F. 2d 201 (C. A. 8, 1955); *United States v. 5139.5 Acres of Land, etc.,* 200 F. 2d 659 (C. A. 4, 1952); *Ambassador Apartments, Inc.,* 50 T. C. 236 (1968), affd. per curiam 406 F. 2d 288 (C. A. 2, 1969). The Parking Lots were purchased in arm's length transactions within a year of the valuation date, and their cost supplies as good an index of their fair market value as the cost of similar lots.

The petitioners also criticize Mr. Reber's technique, on the grounds that he did not "verify" the cost data relating to the post-1959 comparable sales. Mr. Reber obtained his data for such sales from the Nevada State Highway Department, who informed him that the sales had been verified by them. Apparently, it is the petitioners' position that data from a third party is inherently unreliable. However, it is well established that an appraiser may use hearsay information in formulating his appraisal, if such information appears to be reliable. *Standard Oil Company of California v. Moore,* 251 F. 2d 188, 221 (C. A. 9, 1957), cert. denied 356 U. S. 975 (1958); *District of Columbia Redevelopment Land Agency v. 61 Parcels of Land,* 235 F. 2d 864 (C. A. D. C. 1956); *International Paper Company v. United States, supra; United States v. 5139.5 Acres of Land, etc., supra.* In this case, we see no basis to question the reliability of the information obtained from the State.

The petitioners contend that the Reber appraisal is also deficient inasmuch as it does not consider all the comparable sales occurring in the vicinity of the Parking Lots. They refer to four sales which they contend were not considered by Mr. Reber. Of those four sales, one occurred in 1957, one occurred in 1958, and two occurred in 1960. The 1957 and 1958 sales were for prices substantially lower than the average prices for comparable sales in those years found by Mr. Reber, and the petitioners have not demonstrated that the omission has prejudiced them in any way. Mr. Reber did not detail the post-1959 comparable sales that he considered in valuing the Parking Lots since such data is not as relevant to determining market value in 1959 as pre-1960 sales. Accordingly, we cannot be certain whether or not Mr. Reber did in fact consider that 1960 sales mentioned by the petitioners. One of such sales was for a price substantially lower than the average post-1959 sales prices considered by Mr. Reber, and the other sale was for a substantially higher price. However, the petitioners have not indicated whether or not the higher-priced sale was of improved realty—if it was, such fact might account for the higher price. In any event, only one of the sales allegedly not considered by Mr. Reber might be helpful to the petitioners, and its omission does not make any significant difference in the result.

The petitioners object to the selection of most of the comparable sales used by Mr. Reber, since such sales were of property used at the times of sales for residential purposes. From this fact, the petitioners conclude that the purchase prices of the comparables were based on their use as personal residences, and that they are not comparable to property the purchase price of which is based on its commercial use. We do not agree. The evidence indicates that all of the comparable sales used by Mr. Reber were of property zoned and appropriate for commercial use.

Furthermore, it is evident that almost all of the purchasers intended to use the properties purchased by them for commercial purposes. There is no indication in the record that the sellers of the comparables sold them with the understanding that they would be used as residential property. In negotiating the purchase price, the sellers would naturally base their sales price on the market value of their property, taking into consideration their potential use as commercial property.

D. Correctness of Rate of Return

The petitioners assert that Mr. Reber's use of a 13-percent rate of return is entirely insufficient to reflect the earning power of the Parking Lots, that he failed to take into consideration that the lease was to run for a 5-year period, and that his allowance of 3 percent for an increase in the value of the property was unrealistic. In support of these contentions, they point out that Mr. Reber's computations indicate increases in land value over the 5-year period from 1959 through 1964 of 27 percent.[3]

The parties to the leases which Mr. Reber used as his comparables, no doubt, took into consideration the likelihood of inflation and increase in the value of the property in fixing the rate of rentals in such leases, and therefore, the average rate of return of approximately 10 percent found by Mr. Reber gave some effect to the expected increase in the value of the Parking Lots. Nevertheless, Mr. Reber added 3 percent to the average in order to give ample effect to the term of the lease and the likely increase in the value of the properties during such term. This addition was more than adequate to cover the actual increase

3. The petitioners' brief states that the land value increase was "at least 20 percent." Actually, such increase was 27 percent, and we have used the latter figure in our discussion.

in the value of the properties. It constituted a 30-percent addition to the annual return on the value of the Parking Lots under the lease; whereas, Mr. Reber's study shows that the property only increased 27 percent in value over the 5 years of the lease, or approximately 5 percent per year. Mr. Reber's objective was to examine the circumstances existing in 1959, and based upon such circumstances, to project the reasonable rental to be expected over the 5-year period of the lease. *Midland Ford Tractor Company v. Commissioner, supra; Brown Printing Co. v. Commissioner, supra; J. J. Kirk, supra; Stanley Imerman,* 7 T. C. 1030 (1946). Although the casino turned out to be a very successful operation, his addition of more than 30 percent to each year's income to take into consideration the likely changes over the term of the lease were generous in the light of what could have been anticipated in 1959.

Although all but one of the 12 comparable leases considered by Mr. Reber involved gambling-associated property, the petitioners argue that there are sufficient differences between the comparables and the Parking Lot Lease to render Mr. Reber's appraisal valueless. The petitioners note that certain of the comparables involved more speculative operations than the Parking Lot Lease. However, if such leases were more speculative, it seems that the rate of return on them should have been higher than on the Parking Lot Lease, and therefore, their use could not prejudice the petitioners. Some of the leases involved property of less value than the Parking Lots; but this difference does not affect the usefulness of such leases—the lesser value reduces the gross rental, but does not affect the rate of return. Other comparable leases are criticized by the petitioners because they involved property not in Sparks, Nevada. However, since all but one of the comparable leases considered by Mr. Reber involved property used in connec-

tion with gambling establishments, we see no reason to reject data from leases on property in different geographic areas, especially since there were few leases of gambling property in Sparks. The petitioners criticize the remaining comparables on the alternative grounds that they were entered into as much as 7 years before the Parking Lot Lease, or were leases of improved realty. The petitioners have suggested no reason why these facts should materially affect the reliability of Mr. Reber's appraisal and we perceive none.

The petitioners object to Mr. Reber's omission of the sublease between Challenger and Nugget Enterprises of the Sparks Nugget Casino. This lease was found to be reasonable in *The Challenger, Inc.*, 23 T. C. M. 2096, 33 P.-H. Memo. T. C. par. 64,338 (1964). We think Mr. Reber was justified in disregarding this lease since the parties thereto were closely related and did not negotiate it at arm's length. In addition, our prior holing was only that the rentals under the lease were reasonable. We expressed no opinion as to the fair rental value of the property which was the object of Mr. Reber's inquiry. Finally, the 80 cents per square foot per year rental under such lease was less than the amount found by Mr. Reber, and considerably less than the amount allowed by the respondent in this case, and consequently, the petitioners are not prejudiced by Mr. Reber's omission of the information concerning the lease approved in the earlier *Challenger* case.

The petitioners point out that Mr. Reber was not conversant with all the terms of either the Parking Lot Lease or the leases which he considered comparable. His testimony indicates that he was aware that the Parking Lot Lease was for a term of 5 years and was renewable, but that he was unaware of the provision in the lease allowing the lessee to terminate in the event gambling was outlawed

in Nevada. The fact that Mr. Reber was unaware of the termination provision does not, we think, diminish the viability of his appraisal. His appraisal report sets forth the term and the rental of each of the comparable leases he employed. Such data is by far the most significant information he required in making his appraisal. We cannot expect appraisers appearing before this Court to be familiar with all the provisions of the legal documents relating to comparable property selected by them in their appraisals.

It appears that Mr. Reber obtained his information on all but two of the comparable leases by talking to persons associated with either the lessor or the lessee. With respect to the other leases, Mr. Reber was unclear as to his source of information, but such information appears to have come to him in his professional capacity during the course of his appraisal. The petitioners contend that such information is inherently unreliable and that Mr. Reber should have consulted the provisions of the leases themselves. As we have noted previously, the appraiser may rely upon hearsay data in formulating his appraisal. In the present case, we do not think that such reliance is untoward or significantly affected the accuracy of the appraisal.

In summary, the petitioners' objections to the Reber appraisal are not well taken. His determination of the fair market value of the Parking Lots at the time of the lease is adequately supported by market data, and his use of 13 percent as the rate of return seems to be appropriate. Accordingly, his conclusion as to the fair rental value of the Parking Lots for the term of Parking Lot Lease is valid.

The petitioners contend that the data relating to most of the other real estate transactions in Sparks included in our Findings of Fact is not relevant, because such transactions are not comparable to the lease of the Parking Lots.

They emphasize that the Parking Lots furnished the most convenient parking for the casino and therefore could command much higher rentals than the other properties leased in Sparks. They also contend that most of the other transactions described in our findings are not pertinent to our inquiry because they involved property which was either improved, leased prior to the opening of the new casino, acquired for employee parking, or acquired for access. Rather, the petitioners take the position that the most significant transactions were the acceptance of the rental provisions of the Parking Lot Lease by Mr. Ascuaga when Sparks Nugget, Inc., acquired Challenger; the renewal of such lease at the same rental in 1964; and the supplemental lease entered into between Sparks Development and Sparks Nugget, Inc., on August 1, 1962.

In our opinion, none of these transactions constitute a showing of substantial error in the Reber appraisal. Sparks Nugget, Inc., controlled by the Ascuagas, acquired the stock of Challenger, controlled by the Graves, on September 30, 1960. Although Mr. Ascuaga was a former employee of Mr. Graves, the evidence indicates that the transaction was one at arm's length. The petitioners point out that, as a condition to the stock purchase, Mr. Ascuaga insisted on the extension of the period for which the Parking Lot Lease could be renewed; from that fact, the petitioners would have us infer that the provisions of the lease were open for renegotiation and that by not renegotiating the rental, Mr. Ascuaga was acknowledging its reasonableness. We do not think such an inference is warranted. In purchasing Challenger's stock, Sparks Nugget, Inc., in effect, acquired the entire properties and liabilities of Challenger for a total unallocated consideration. In such a situation, the purchase price may be allocated among the various items of property owned by the acquired corporation in any

manner desired by the parties. For example, if Sparks Nugget, Inc., felt that the rental under the Parking Lot Lease was unduly high, a readjustment of the rent would not be necessary if there was a downward adjustment in the purchase price of the stock. The fact that the period of the lease was renegotiated is not persuasive to us. Although excessive rentals under the lease could be compensated by an adjustment in the purchase price of the Challenger stock, no such adjustment was possible with respect to the length of the lease. The Parking Lots were important to the casino's success, and the only way Sparks Nugget, Inc., could assure itself of their continued availability was by securing a modification of the lease. An adjustment in the purchase price of the stock could not take the place of lengthening the lease.

Equally unpersuasive is the fact that Sparks Nugget, Inc., renewed the Parking Lot Lease in 1964 at the same rental of $8,000 per month. Although Mr. Reber did not appraise the Parking Lots as of the renewal date, his records do show that the average sales price of comparable pieces of property increased from $5.99 per square foot in 1959 to $7.57 per square foot in 1964, an increase of 27 percent. If the Parking Lots increased in value by this same percentage, the annual rental of $2.12 per square foot for the renewal term is only a 27-percent annual rate of return based on the 1964 value of the Parking Lots as opposed to a 34-percent rate of return based on the 1959 value. Thus, although the lease was renewed at the same rental, the rate of return was actually reduced, despite the fact that between 1959 and 1964, the casino operation expanded considerably, resulting in a greater need for parking and a diminution of available parking space. What is more, although we have found that Sparks Development and Sparks Nugget, Inc., dealt at arm's length, we do not necessarily

find that each individual transaction between them was for a consideration representing fair market value. Sparks Nugget, Inc., was, to a certain extent, dependent for its success on the good will of Sparks Development and its owners, the Graves. During 1964, Sparks Development and the trusts established by the Graves were leasing the casino premises and at least two additional parking lots to Sparks Nugget, Inc. Additionally, payments for the Challenger stock were still being made to the Graves by Sparks Nugget, Inc., pursuant to the purchase agreement; accordingly, Sparks Nugget, Inc., could not make capital expenditures in excess of $10,000 per year without the Graves' approval. Furthermore, Mr. Graves was the controlling stockholder of Nugget Motor Lodge, Inc., which owned and operated a motel supplying considerable business to the casino. Finally, the Graves owned a small amount of the stock of Sparks Nugget, Inc. These various associations between lessor and lessee diminish the reliability of the rental paid for the renewal term of the Parking Lot Lease as an index of fair rental value of the Parking Lots.

The petitioners contend that the terms of the supplemental lease also call into question the conclusions of the Reber appraisal. They point out that although this lease involved property not as valuable to the casino operation as the Parking Lots, the rental was $1.68 per square foot—only 44 cents per square foot less than the rental of the Parking Lots under the Parking Lot Lease, 87 cents per square foot more than the Reber appraisal of the fair rental value of the Parking Lots, and 62 cents per square foot more than the reasonable rental allowed by the respondent. Since the properties subject to the supplemental lease (Lots 1 and 2 in Block 1, Lot 4 in Block 4, and Lots 22, 23, and 24 in Block 5) were further from the casino than the Parking Lots, we agree with the petitioners'

contention that they were not as valuable for parking purposes as the Parking Lots. However, Mr. Reber determined the fair rental value of the Parking Lots as of June 17, 1959, based upon the facts existing at that time and those reasonably foreseeable. By 1962, when the supplemental lease was made, there had been a spectacular expansion in the casino operations, a reduction in the available parking, and a vastly increased need for parking spaces. These circumstances indicate a demand for parking that was not foreseeable as of 1959 and explain why there may have been an increase in the value of properties in the vicinity of the casino that was not reasonably foreseeable as of 1959.

The most useful comparison, we think, can be drawn with respect to Lots 1-8 in Block 3, which have been used for both parking and as the casino premises. The Trustee owned these premises and initially leased them to Challenger on May 1, 1957, for parking, before the new casino was built. The rental established under this lease was not to exceed 59 cents per square foot. Subsequently, on September 23, 1957, the lease with Challenger was cancelled and the Trustee leased the premises to Nugget Enterprises for 80 cents per square foot. The lease has a 20-year term and a 10-year renewal option and provides that the rent be renegotiated every 5 years. Nugget Enterprises constructed the casino on a part of the premises and subleased it to Challenger. On January 1, 1962, the lease between the Trustee and Nugget Enterprises was amended to provide a rental of $1.27 per square foot. If the 1957 rental and the 1962 rental under this lease represent the fair rental value of the casino property on those dates and if the fair rental value increased ratably over that period, the fair rental value of the property on June 17, 1959, was approximately 99 cents per square foot. This figure is 18 cents

higher than the fair rental value of the Parking Lots found by Mr. Reber and 7 cents lower than the rental allowed by the respondent in his determination. These premises, as we have noted, were used for parking and as the site of the casino. There is every reason to believe that they were at least as valuable as the Parking Lots and had as high a rental value per square foot as the Parking Lots. In addition, the lessor of the premises was the trustee of trusts for the Graves' children. It was therefore under a fiduciary duty of care not to lease the premises for an unfairly low rent.

The petitioners have attempted to support the reasonableness of the rental under the Parking Lot Lease by the testimony of Paul A. Walters, an operator of commercial parking lots in Reno. Mr. Walters testified that the charge for parking space in Reno was 50 cents for 4 hours. He felt that the casino could charge 50 cents for 3 hours parking since the Parking Lots were very convenient to the casino. He also believed that each parking space in the Parking Lots would turn over four to five times daily. He concluded that each space would return $2.25 to $2.50 per day or about $75 per month. The petitioners point out that the Parking Lots contained 143 parking spaces, which, at $75 per month, would yield more per month than the rental paid in respect of such spaces under the Parking Lot Lease. We do not find this testimony persuasive. Mr. Walters' estimates were based upon the gross receipts to be derived from the parking spaces and did not take into consideration any expenses for overhead, personnel, taxes, etc. Furthermore, he was comparing the fees that could be charged for parking in an area which included a variety of businesses. We are not convinced that the patrons of the casino would have paid comparable fees for parking. The uses of the parking spaces which Mr. Walters had in mind are too

different from the uses of the parking spaces near the casino to make comparisons reliable.

The petitioners have sought to convince us of the reasonableness of the rentals provided under the Parking Lot Lease. Nothing in the evidence supports their position. The rental of $2.49 per square foot for the first year of the lease term is a 45-percent annual rate of return on Mr. Graves' cost of acquiring the Parking Lots; the rental of $2.12 per square foot for the last 4 years of the initial lease term is a 38-percent annual return on cost. The evidence clearly indicates that the value of the Parking Lots at the time the lease was executed was not substantially greater than the cost to Mr. Graves. It is equally apparent that Sparks Development incurred little risk and less expense in leasing the Parking Lots. In light of these facts, the record clearly indicates that a rental which allows total cost recovery in less than 3 years is wholly excessive.

After considering all these facts and arguments, we have concluded that the reasonable rental of the Parking Lots during the term of the Parking Lot Lease did not exceed $4,000 per month, or $1.06 per square foot per year, the amount allowed by the respondent in his determination. Mr. Reber's determination that the fair rental value was 81 cents per square foot per year appears to be reliable. It represents a return of 13 percent on the fair market value of the property. The respondent's allowance represents a return of 17 percent on the fair market value of the Parking Lots. Although we have carefully analyzed each step of Mr. Reber's analysis and carefully considered the other evidence offered by the petitioners, there is nothing to convince us that his conclusions are significantly in error; there is nothing to lead us to believe that his allowances should be increased by enough to offset the additional allowance already approved by the respondent. Accordingly, we hold that the amounts paid under the Parking Lot

Lease, to the extent that they exceed $4,000 per month, were not required to be paid under such lease and are not deductible under section 162.

II. *Constructive Dividends to the Graves*

The respondent has determined that Challenger could not deduct in full the amounts paid by it with respect to the Parking Lot Lease and its lease of 100 slot machines. He further determined that the amounts so disallowed constitute a constructive dividend to the Graves as shareholders of Challenger, since the money was paid for their benefit by one corporation owned by them to other corporations owned by them.

Although Sparks Nugget, Inc., transferee of Challenger, has contested the correctness of the disallowance of rental deductions with respect to the Parking Lots, it has conceded the correctness of the respondent's determination disallowing Challenger rental deductions for payments made to Pub, Waldorf, and Saratoga with respect to the slot machines. However, the Graves, for purposes of determining the amount of any constructive dividends to them, do dispute the question of whether any amounts paid in respect of the slot machines may be disallowed to Challenger as rental deductions.

In its taxable year ending September 30, 1959, Challenger paid Pub, Waldorf, and Saratoga a total of $97,336.07; in its taxable year ending September 30, 1960, Challenger paid such corporations a total of $103,821.15. Challenger claimed these amounts as rental expense for the 100 slot machines leased from such corporations. Computed on a monthly basis, these figures result in a monthly rental of $81.11 per machine in Challenger's 1959 taxable year, and $86.52 in its 1960 taxable year. In *The Challenger, Inc.*, 23 T. C. M. 2096, 33 P.-H. Memo T. C. par. 64,338 (1964),

involving Challenger's taxable years 1955 through 1958, this Court found that the reasonable monthly rental for the slot machines did not exceed $2.59 per machine. The respondent contends that the doctrine of collateral estoppel operates to bar us from again examining the reasonable rental of the slot machines and that for purposes of the Graves' tax liability, we must consider all amounts paid in respect of the slot machines which exceed $2.59 per month per machine as unreasonable and nondeductible by Challenger under section 162(a)(3).

The petitioners repeat their argument that section 162 (a)(3) puts no limit on the amount deductible as rental deductions for payments made pursuant to an enforceable leasing agreement. They next argue that even if such a limit does exist, the conclusion reached with respect to reasonable rental in the *Challenger* case was erroneous and that they are not collaterally estopped to show as much. Finally, they argue that even if excessive amounts were paid by Challenger to Sparks Development for the Parking Lots, and to Pub, Waldorf, and Saratoga for the slot machines, such amounts do not constitute constructive dividends to the Graves.

We cannot agree with any of these contentions.

We have already held that section 162(a)(3) does not operate to bar inquiry into the reasonableness of amounts claimed as rental deductions, at least when the lessor and lessee are closely related parties not dealing at arm's length. We must next consider whether the amounts claimed as rental deductions under the slot machine lease were reasonable.

The petitioners argue that collateral estoppel cannot be applied in this proceeding, since the parties against whom it is sought to be invoked were not parties in the earlier *Challenger* case, and since there has been an intervening

change in applicable legal principles. It is true that the Graves were not technically parties in the prior proceeding. However, collateral estoppel may be applicable when the later case involves the same parties as in the earlier proceeding, or when it involves parties who were in privity with the parties in the earlier proceeding. *Sunshine Coal Co. v. Adkins,* 310 U. S. 381 (1940). Stockholders are considered to be in privity with their corporation, and, if the other requirements of collateral estoppel are present, they cannot relitigate determinations rendered in a proceeding involving the corporation. *D. Bruce Forrester,* 4 T. C. 907 (1945); *Jahncke Service, Inc.,* 20 B. T. A. 837 (1930), appeal dismissed per curiam 112 F. 2d 169 (C. A. 5, 1933). See also *Seaboard Commercial Corporation,* 28 T. C. 1034 (1957); *American Range Lines, Inc.,* 17 T. C. 764 (1951), affd. on this issue 200 F. 2d 844 (C. A. 2, 1952). Moreover, it seems manifestly reasonable to apply the doctrine in the present case. The Graves were the sole shareholders of Challenger, Pub, Waldorf, and Saratoga at the time of the previous proceeding. The petitioners in that proceeding vigorously defended the propriety of the rental deductions claimed by Challenger in respect of its leasing of the slot machines. It is plain that the Graves were as much concerned with the outcome of the prior proceeding as if they had been parties thereto, and we see no reason to allow them to relitigate questions previously decided merely because they were not technically parties in the *Challenger* case.

We also see no merit in the petitioners' contention that there has been a substantial modification in the law since the decision in the *Challenger* case. *Commissioner v. Sunnen,* 333 U. S. 591 (1948). As support for this position, the petitioners point to the case of *Royal Farms Dairy Co.,* 40 T. C. 172 (1963), and *Estate of Sol Goldenberg,* 23 T. C. M. 810, 33 P.-H. Memo T. C. par. 64,134 (1964). In each of these cases, we disallowed a portion of a rental deduction on the grounds that the amount treated as rent was unreason-

able and was not required to be paid within the meaning of section 162(a)(3). Both cases were appealed by both the respondent and the petitioners to the Court of Appeals for the Ninth Circuit; but the appeals were dismissed by the court pursuant to the following stipulations of the parties:

> It is hereby stipulated by and between the parties hereto, through their Counsel, that the Commissioner of Internal Revenue dismiss his petition for review of the above decision and that the taxpayer dismiss its petition for review of the above decision, with no cost to either party, and that the case be remanded to the Tax Court with directions to enter a revised decision providing for a recomputation of deficiencies to permit the taxpayer deductions for the payments it claimed as "rent" in the above case.

The petitioners argue that this concession by the respondent constitutes an acknowledgment by him that amounts paid as rent are deductible without regard to their reasonableness. However, we think that no such interpretation of the respondent's action is warranted. In the first place, he merely conceded the deductibility of the rental payments involved in these cases, and that concession may have been due to a recognition that he could not successfully establish that the rental payments were unreasonable. Furthermore, those cases involved a different principle of law, because in them the lessor and lessee were unrelated parties; whereas, in both the earlier *Challenger* case and in this case, the lessor and the lessee were related parties not dealing at arm's length.

We hold that the doctrine of collateral estoppel bars the petitioners from relitigating the question of the reasonable rental of the slot machines.[4]

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4. The earlier *Challenger* case involved Challenger's taxable years 1955 through 1958, and the present case involves the reasonableness of the rental of the slot machines for its taxable years 1959 and 1960. Obviously, the issue of fact in this proceeding is not

Having found that Challenger paid excessive rentals under the Parking Lot Lease and for use of the slot machines, we reach the question of whether such excessive amounts constitute constructive dividends to the Graves. According to the respondent, Challenger served no corporate purpose of its own by paying excessive rentals to Sparks Development, Pub, Waldorf, and Saratoga. Challenger made such payments only because the Graves owned and controlled it and the other corporations. The Graves arranged to have Challenger make the excessive payments for their benefit. In effect, the Graves were thereby transferring funds from one corporation owned by them to other corporations owned by them. It was as if Challenger had distributed the excessive amounts to the Graves, and they in turn contributed them to the other corporations.

Section 316 defines a dividend as a distribution of property by a corporation to its shareholders out of earnings and profits. For tax purposes, a dividend need not be formally declared as such by the corporation. *Barbourville Brick Co.*, 37 T.C. 7 (1961). Nor is it necessary that the distribution be made directly by the corporation to its shareholders. A distribution by a corporation to a third party for the benefit of a shareholder constitutes a constructive dividend, which will be taxed as a dividend to the shareholder for whose benefit the distribution is made. *Worcester v. Commissioner*, 370 F. 2d 713 (C. A. 1, 1966), affg. in part a Memorandum Opinion of this Court; *Equi-*

identical to the issue previously determined—the reasonable rental of the slot machines is not a static fact but is rather a recurring one which may change from year to year. However, this difference does not provide a basis for not applying collateral estoppel. In the first place, the petitioners have not raised the issue. In the second place, they have introduced no evidence in this proceeding tending to prove that a material change of facts occurred between the years involved in the *Challenger* case and those involved in this proceeding—they merely offered and criticized the Court's conclusion with respect to the earlier years. See *Estate of William G. McGuire*, 50 T. C. 130 (1968).

table Publishing Company v. Commissioner, 356 F. 2d 514 (C. A. 3, 1966), affg. per curiam a Memorandum Opinion of this Court, cert. denied 385 U. S. 822 (1966); *Biltmore Homes, Inc v. Commissioner*, 288 F. 2d 336 (C. A. 4, 1961), affg. a Memorandum Opinion of this Court, cert. denied 368 U. S. 825 (1961); *Helvering v. Gordon*, 87 F. 2d 663 (C. A. 8, 1937), revg. 29 B. T. A. 275 (1933); *L. L. Silverstein*, 36 T. C. 438 (1961); *Limericks, Inc.*, 7 T. C. 1129 (1946), affd. 165 F. 2d 483 (C. A. 5, 1948). The benefit conferred by such a distribution need not be of a direct financial nature. It may be merely the pursuit of a hobby, the fulfillment of a moral obligation, or the making of a gift. *W. D. Gale, Inc. v. Commissioner*, 297 F.2d 270 (C. A. 6, 1961), affg. a Memorandum Opinion of this Court; *Byers v. Commissioner*, 190 F. 2d 273 (C. A. 8, 1952), affg. a Memorandum Opinion of this Court, cert. denied 345 U. S. 907 (1953); *Commissioner v. Greenspun*, 156 F. 2d 917 (C. A. 5, 1946), revg. in part a Memorandum Opinion of this Court, *Montgomery Engineering Company v. United States*, 230 F. Supp. 838 (D. N. J. 1964), affd. per curiam 344 F. 2d 996 (C. A. 3, 1965); *Standwick's Inc., supra*. The essence of a constructive dividend is a distribution of corporate earnings for the private purposes of a shareholder. Cf. *Helvering v. Horst*, 311 U. S. 112 (1940).

The petitioners argue that no tax or other benefit accrued to the Graves by virtue of any excessive rentals paid by Challenger to Sparks Development, Pub, Waldorf, and Saratoga. The Graves wholly owned all of the corporations, and all of them were in the highest corporate tax bracket. In their view, any unjustified transfer of funds had no greater effect than the transfer of funds by an individual from one bank account to another. We cannot agree with this contention since the Graves secured substantial benefits by virtue of the arrangement.

Although Mr. Graves was aware that the excessive rentals would not have any corporate tax effect, he believed the amount of the rentals could reduce his personal income taxes. We do not know what benefit he had in mind, but from an examination of the objective facts, we can see the benefits which he derived from the arrangements. He operated his business through many corporations. The casino business itself was owned by one corporation, Challenger; the building and land on which it was built were owned by another organization, the joint venture; the slot machines were owned by other corporations; and the Parking Lots by still another corporation. Mr. Graves tsstified that he always had in mind retiring early, and this division of his business into several organizations facilitated the sale of the casino business, leaving him with investment properties from which he could derive income with a minimum of active management on his part. When he transferred funds from one corporation to another, the transfer had a good deal more significance than a transfer from one bank account to another. Because Challenger paid excessive rentals for the use of the slot machines to Pub, Waldorf, and Saratoga, those corporations had available funds to be used in the construction of the casino building that would otherwise have had to be obtained in some other manner. For example, without such excessive rentals, it might have been necessary for Mr. Graves to make capital contributions to such corporations out of his income on which he paid taxes. Similarly, when he established the rental to be paid to Sparks Development for the use of the Parking Lots, it was set high enough to provide the funds necessary to pay off the obligations incurred in the purchase of the Parking Lots. Had the rentals been set at a lower figure—at the amount which would have been paid in the market place for the rental of such Parking Lots, it would have been necessary

for Sparks Development to have secured additional capital in some other manner, for example, by contributions from Mr. Graves. In other words, as a result of the payment of excessive rentals, the equity in Sparks Development, Pub, Waldorf, and Saratoga was increased, and when the Challenger stock was sold to the Ascuagas, the Graves were left with valuable corporations, Sparks Development, Pub, Waldorf, and Saratoga.

The petitioners contend that the excessive rentals amounted to nothing more than capital contributions by Challenger to its sister corporations. See sec. 362(c). In support of this contention, they have cited cases holding that payments by nonstockholders to a corporation may constitute capital contributions. *Brown Shoe Co. v. Commissioner*, 339 U. S. 583 (1950); *Edwards v. Cuba Railroad*, 268 U. S. 628 (1925); *Federated Department Stores, Inc.*, 51 T. C. 500 (1968); *Sherwood Memorial Gardens, Inc.*, 42 T. C. 211 (1964); *Foresun, Inc.*, 41 T. C. 706 (1964), affd. in part 348 F. 2d 1006 (C. A. 6, 1965); *Veterans Foundation*, 38 T. C. 66 (1962), affd. 317 F. 2d 456 (C. A. 10, 1963). Although we agree that capital contributions do not constitute taxable income, it is still necessary to examine the surrounding circumstances to determine whether funds were transferred for the purpose of making a capital contribution, and the circumstances of this case do not indicate that the excessive rentals were paid for such a purpose. When a person who is not a shareholder makes a contribution to the capital of a corporation, he does so because he expects to benefit materially or otherwise from the corporation having the additional capital. Challenger could expect no benefit to itself from the payment of the excessive rentals. Indeed, it could have purchased the slot machines with the amounts it paid each year for the rentals, and Challenger derived no benefit from the fact that its exces-

sive rentals enabled Sparks Development to pay off quickly the loans incurred in purchasing the Parking Lots. It seems altogether clear that if Challenger had been independent from control by the Graves, it would have had no reason to make capital contributions to those corporations which received the excessive rentals. They were paid because Mr. Graves willed it so, not because Challenger benefited thereby.

The petitioners contend that Challenger was under a legal obligation to pay the full amount required as rent under the Parking Lot Lease and the slot machine lease. We need not pass on the effect of local law. The provisions of the Internal Revenue Code take precedence over local law in determining the tax consequences of a transaction. For Federal tax purposes, the amounts claimed by Challenger as rental deductions were not required to be paid as rent, irrespective of whether the leases were enforceable under local law. Even if the sums were required to be paid under local law, such fact does not relieve the Graves of dividend liability when the sums so paid were in substance a distribution of corporate earnings.

Finally, the petitioners argue that there is no justification in taxing the excessive rental payments as dividends since such payments remained in corporate solution after the payments were made, and since they would be taxable when eventually distributed to the Graves. In effect, it is argued that funds may be transferred from one corporation to another without tax consequences since nothing has actually been distributed to the shareholders. However, this argument overlooks the fact that each corporation is considered a separate legal person for tax purposes, and in the absence of some specific statutory or other exception, a transfer of funds from one corporation to another has immediate tax consequences. If one corporation sells goods or furnishes services to another corporation, such trans-

actions must be recognized and given effect in determining the taxation of the corporations. Likewise, when, as in this case, there is a transfer of funds between corporations, the transfer must have some effect upon the capital or earnings and profits of the corporations. The effect of such transfer cannot be ignored. We have found that, in this case, the transfer was for the benefit of the Graves. It was in effect a contribution to capital by them, and that fact will influence the tax treatment of the corporations which received the transfer. Finally, it does not follow, as claimed by the petitioners, that the excessive rentals will eventually be taxed to the Graves when distributed by Sparks Development, Pub, Waldorf, and Saratoga. There is no certainty that such payments will ever be distributed to the Graves, and the taxation of any distributions to the Graves will depend upon other circumstances existing at the time of such distribution.

III. *Payments by Sparks Development to Mr. Graves*

The final issue for our consideration is whether $8,539.01 paid by Sparks Development to Mr. Graves in its taxable year ending November 30, 1961, is deductible under section 162(a). That provision states in part:

> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—
>
> (1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

Mr. Graves testified at the trial of this proceeding as to the services he rendered Sparks Development from the time of its formation. Through his efforts, Sparks Development acquired and leased various parcels of realty. It is obvious that most of these activities occurred in years other than Sparks Development's taxable year 1961. There is no evi-

dence before us of any activity by Sparks Development during such year other than its collection of payments made by Challenger pursuant to the Parking Lot Lease and its payment on account of indebtedness incurred when it purchased the Parking Lots. However, the record does indicate that Mr. Graves engaged in protracted negotiations for a parcel of property acquired by Sparks Development on October 29, 1962, and we have inferred that some of such negotiations did occur in 1961. Furthermore, since Mr. Graves was compensated under an arrangement by which he received a percentage of the earnings of Sparks Development, it is clear that the adequacy of his compensation must be judged over a period of years. See *California Vegetable Concentrates, Inc.*, 10 T. C. 1158 (1948). Although he performed few services for Sparks Development in 1961, he apparently performed extensive services for the corporation in other years. Obviously, Mr. Graves is a highly qualified businessman, and his services are very valuable. In view of the nature of the arrangement for his compensation, and the extensive and valuable services performed by him over the years for Sparks Development, we have found that the compensation paid him during that year was not excessive, and we hold that the entire amount, $8,539.01, is deductible.

Decisions will be entered under Rule 50.

Appendix B

SPARKS NUGGET, INC., et al.,
Petitioners-Appellants,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 26504.
United States Court of Appeals,
Ninth Circuit.
April 6, 1972.

Before ELY and CHOY, Circuit Judges, and BYRNE,* District Judge.

WILLIAM M. BYRNE, District Judge:

Appellants Sparks Nugget, Inc. (Sparks Nugget), and R. L. and Flora Graves (sometimes referred to as the Graves), taxpayers whose petitions for redetermination of the Commissioner's assessments of additional taxes were consolidated for trial, have appealed to this court to reverse the Tax Court's decision sustaining the said assessments. Jurisdiction to rule on the merits of this appeal has been conferred under Section 7482 of the Internal Revenue Code of 1954.

During 1958 and 1959, R. L. Graves acquired six and one-half lots located in Sparks, Nevada, at a cost of $253,609.04. On June 3, 1959, he transferred title to the lots

*Honorable William M. Byrne, United States Senior District Judge, Central District of California, sitting by designation.

to Sparks Development Company (Sparks Development), a Nevada corporation wholly owned by the Graves, for cash, an assumption of liabilities and a note, totaling $253,253.05, and for additional Sparks Development common stock with a par value of $20,000. Upon acquiring title to the lots, Sparks Development borrowed $150,000 from the Nevada Bank of Commerce, of which $115,000 was secured by a first deed of trust on several of the lots.

In June of 1959, Sparks Development leased the six and one-half lots to Challenger, Inc. (Challenger), a Nevada corporation wholly owned by the Graves, for a term of five years at a monthly rental of $9,400 the first year and $8,000 the next four years. These lots were used by Challenger as parking lots in connection with its operation of a gambling casino known as the Sparks Nugget Casino (the casino). The financial success enjoyed by the casino was attributable, in part, to its ability to make available, by way of the leased lots, ample free parking to its customers.

The lease agreement negotiated by R. L. Graves on behalf of both Challenger and Sparks Development determined the rental on the basis of the amount of income that Sparks Development would need to pay R. L.'s compensation, its income tax and its purchase obligation on the parking lots. Pursuant to the terms of the lease, Challenger was required to keep the premises in good repair, to maintain liability insurance and to pay the utilities as well as the real property taxes. Additionally, Challenger bore the cost of improvements, including the cost of resurfacing.

Sparks Nugget is a Nevada corporation which was incorporated on September 29, 1960. From the time of its incorporation until June 26, 1961, all of Sparks Nugget's outstanding stock was owned by John and Rose Ascuaga. On that day, the Graves secured ownership of 1.2 percent of the outstanding stock.

The day following its incorporation, September 30, 1960, Sparks Nugget purchased all of the outstanding stock of Challenger from the Graves. Thereafter, on June 30, 1961, Challenger was dissolved and all of its assets were distributed in complete liquidation to Sparks Nugget. Prior to trial, Sparks Nugget acknowledged that as transferee of Challenger's assets, it was liable for any deficiencies determined in the income taxes of Challenger for taxable years 1959 and 1960.

During the taxable years 1959 and 1960, Challenger's parking lot rental expenditures totaled $37,000 and $107,200, respectively. Acting under Section 162[1] of the 1954 Code, the Commissioner disallowed rental deductions claimed by Challenger with respect to the parking lots to the extent the monthly payments exceeded $4,000 on the ground that such excess amounts were not ordinary and necessary business expenses required to be made for the use of the lots. The Tax Court sustained this disallowance, finding that "The reasonable rental of the parking lots during 1959 and 1960 did not exceed $4,000 per month." Those portions of the payments which were in excess of this "reasonable rental" value were deemed constructive dividends to the Graves.

The taxpayers have challenged the Tax Court's invocation of Section 162. In their view, the disallowance of excessive rentals paid between related parties is the exclusive

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1. Section 162 of the 1954 Code provides in pertinent part as follows:

> "(a) In general.—There shall be allowed all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—
> (3) rentals or other payments required to be made as a condition to the continued use or possession of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

domain of Section 482.[2] If that were not so, maintains the taxpayers, that section's provisions, as well as its explicating regulations, would be more redundancies, in that the general provisions of Section 162 would also be controlling of related, controlled or affiliated businesses. The significance of this section's applicability to the instant controversy is, according to the taxpayers, that the Commissioner would be precluded from effecting any taxable increase to the income of the Graves.

The asserted pre-eminence of Section 482 in determining the tax consequences of rental agreements among so-called related parties is said to be underscored by the holding of Rubin v. C. I. R., 429 F.2d 650 (2d Cir. 1970). There, fees were paid to a corporation for managerial service rendered by its controlling shareholder to a second corporation controlled by the same shareholder. Pursuant to Section 61, the Tax Court ruled that the money paid the taxpayer's corporation, in fact, constituted income of the taxpayer because he was the "true earner" of the money and that "in substance" he was directly in the employ of the second corporation. The Court of Appeals deemed the Tax Court's "approach" to be in error, holding that "resort to 'common-law' doctrines of taxation and the broad sweep of § 61" was unnecessary because there was "a statutory provision adequate to deal with the problem presented." The court

2. Section 482 of the 1954 Code provides as follows:
"Allocation of income and deductions among taxpayers.
"In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses."

remanded the case to the Tax Court for consideration of the substantive and procedural questions surrounding the "Commissioner's claim under § 482." On remand (56 T.C. 1155) the Tax Court, noting that the Second Circuit had not "disturb[ed]" its findings, determined that under these "particular" facts, allocation of income pursuant to Section 482 was appropriate.

Although the somewhat distinctive factual setting of *Rubin*, no doubt, was the principal factor responsible for the Second Circuit's analysis, the present mundane controversy does not require that we too add a new wrinkle to the law. As we view the issue, this case is yet another example of evaluating a rental agreement negotiated by closely related parties. The standards for such an evaluation have been well established by the courts. In essence, it has been consistently held that payments in excess of reasonable rent made pursuant to an agreement between closely related parties which was not the product of arm's length negotiation are not deemed "required" and thus are not deductible under Section 162(a) (3). Southeastern Canteen Co. v. C. I. R., 410 F.2d 615 (6th Cir. 1969), cert. denied, 396 U.S. 833, 90 S.Ct. 89, 24 L.Ed.2d 84 (1969); Potter Electric Signal and Manufacturing Co. v. C. I. R., 286 F.2d 200 (8th Cir. 1961); Midland Ford Tractor Co. v. C. I. R., 277 F.2d 111 (8th Cir. 1960), cert. denied, 364 U.S. 881, 81 S.Ct. 169, 5 L.Ed.2d 102 (1960); Utter-McKinley Mortuaries v. C. I. R., 225 F.2d 870 (9th Cir. 1955). See, Van Keppel Co. v. United States, 321 F.Supp. 1183 (W.D.Mo.1971).

A recent example of the thinking which has long prevailed is Southeastern Canteen Co. v. C. I. R., supra. There the Sixth Circuit upheld the Tax Court's disallowance of part of the taxpayer's deduction for rental payment paid pursuant to the sale-leaseback agreement negotiated be-

tween corporations controlled by the same individuals. In so ruling, the court relied upon the following general rules:

> "The fact that the parties designated, and one party became obligated to pay to the other, a specified amount as rent does not bind the government to treat that amount as rent. (Citations omitted). Where there is an absence of arm's length dealing, the Commissioner may inquire into what constitutes reasonable rental to determine whether the amount paid exceeds what would have been paid had the parties dealt at arm's length." 410 F.2d at 619.

Applying these rules, the Court adopted the following analysis of the Tax Court as its own:

> "Petitioners' position is further weakened by the fact that during the entire negotiations leading up to the execution of the sale-leaseback agreements, the owner of both the lessor (Gladco) and the lessees (petitioners) was the same person, Virgil Gladieux. Petitioners' attempt to transform such an identity of interest into a relationship which petitioners characterize as adverse, transgresses reasonable imagination. All the more so since the facts show that the sale-leaseback agreements were not intended to be ends in themselves but merely steps in an integrated plan to secure to Virgil and ABC advantages which could not benefit petitioners in any meaningful way. From a review of all the facts bearing on this issue, which have been set out at length in our findings, we are convinced that the sale-leaseback agreements in question were not the result of arm's length negotiation between adverse parties and, therefore, we must determine whether the purported rentals were 'in excess of what the lessee[s] would have been required to pay had . . . [they] dealt at arm's length with a stranger.' Roland P. Place, *supra*." 410 F.2d at 620.

As was true in *Southeastern Canteen*, we are also persuaded by the Tax Court's application of the established principles to the facts of the instant case. Specifically, we are in full accord with that court's conclusion "that the Parking Lot Lease was negotiated between closely related parties not dealing at arm's length." The bases of our accordance is the Tax Court's three-step analysis, summarized as follows: (1) The Graves were the sole shareholders of Challenger and Sparks Development; (2) R. L. Graves being the principal executive officer of both corporations, in effect, "negotiated" the lease agreement in his own mind; (3) the rent "agreed upon" did not reflect the actual value of the lease but served to aid Sparks Development in paying R. L. Graves' salary and in meeting its purchase obligation on the parking lots. See, Potter Electric Signal and Manufacturing Co. v. C. I. R., supra; Midland Ford Tractor Co. v. C. I. R., supra.

In the absence of arm's length negotiations "an inquiry into what constitutes reasonable rental is necessary to determine whether the sum paid is in excess of what the lessee would have been required to pay had he dealt at arm's length with a stranger." Place v. C. I. R., 17 T.C. 199, 203 (1951), aff'd., 199 F.2d 373 (6th Cir. 1952), cert. denied, 344 U.S. 927, 73 S.Ct. 496, 97 L. Ed. 714 (1953). Here, the Tax Court weighed the evidence relating to the determination of the amount constituting monthly rent and concluded that it was an unreasonable sum of money. In the Tax Court's view, the value of the parking lots did not exceed $4,000 per month for the years 1959 and 1960. Unlike the taxpayers, we find this view to be embedded in a sound evidentiary foundation.

Arthur Reber, a professional appraiser who "has appraised numerous properties in the State of Nevada, including at least one gambling establishment . . . (as well

as) numerous commercial properties including parking lots," prepared an appraisal of the fair rental value of the parking lots which the Tax Court believed adequately reflected the parking lots' value to Challenger because it was based on the prior prices paid "in the market place for properties used in connection with the casino's operations." Reber determined that the annual fair rental value of the parking lots was $36,681, an amount considerably less than the $48,000 allowed by the Commissioner and approved by the Tax Court.

In addition to Reber's appraisal, the Tax Court's decision is supported by the fact that the lease agreement between Challenger and Sparks Development was not meant to reflect the true rental value of the parking lots. As already noted, the rent was determined on the income needs of lessor Sparks Development. Thus, the "negotiating" parties agreed to a fundamental term of the lease agreement absent any consideration of the reasonable rental value.

It is also noteworthy that during the first year of the lease, Challenger's rental payments amounted to a 45 percent annual rate of return on the original cost of the lots (as already indicated, R. L. Graves purchased the lots for a total of $253,609.04). For the next four years of the lease, the rental payments yielded an annual rate of return of 38 percent. The higher rental payments imposed on Challenger for the first year reflected the higher loan payments required of Sparks Development in that year.

The taxpayers maintain that the Tax Court's assessment of the parking lots' rental value was in error because it failed "to consider all the evidence." Specifically, they maintain that Reber's appraisal cannot be viewed as reliable because it did not take into account the 34 percent return earned by the Challenger on the casino and related operations. Implicit in this challenge of the appraisal's re-

liability is the suggestion that the said rate of return should be correlated to the importance of the parking lots. Because Reber's appraisal failed to appreciate this correlation, it should not have been used by the Tax Court as a standard to evaluate the rental payments made to Sparks Development.

Although the importance of the parking lots to the casino's success cannot be discounted, it is not a true reflection of the evidence to correlate the two together. At trial, General Manager John Ascuaga twice indicated "that parking and fine food were [the] two big reasons for [the casino's] success." Additionally, the casino, which was the recipient of R. L. Graves' managerial talents, provided lounge entertainment to its customers. In short, the evidence clearly indicates that credit for the financial success enjoyed by the casino was to be shared by a host of factors. Accordingly, we glean no error from appraiser Reber's failure to consider the rate of return in calculating his computations.

Equally unpersuasive is the taxpayer's complaint that the Tax Court ignored the testimonial opinions of Ascuaga and R. L. Graves that the rent for the parking lots was "fair." The Tax Court's refusal to give great weight to the views opined by Ascuaga and R. L. Graves is embedded in the strong evidentiary inference that self-interest motivated the espousal thereof. Ascuaga and Graves, who were long-time business associates, each, no doubt, had special reason to vouch for the fairness of the rental terms. Simply stated, Ascuaga's concern was to have use of the parking lots and R. L. Graves was intent on Challenger being able to deduct in full the rent paid in 1959 and 1960. Under these circumstances, it was not unreasonable for the Tax Court to have trepidations about their testimony. See, Simon v. C. I. R., 285 F.2d 422 (3rd Cir. 1960); Mid-

land Ford Tractor Co. v. C. I. R., 277 F.2d 111 (8th Cir. 1960).

As indicated above, the Graves also challenge the Tax Court's conclusion that those portions of the rental payments made by Challenger not deductible under Section 162 constitute constructive dividends. According to the Graves, no such dividend can be attributable to them because they were not the beneficiaries of these payments. Illustrative of this point is said to be the holding in Holsey v. C. I. R., 258 F.2d 865 (3rd Cir. 1958). There, the taxpayer, a 50% owner of the Holsey Company, assigned his option to purchase from the Greenville Company the remaining 50% of Holsey to that company, which in turn, exercised the option for $80,000. The end result of this transaction was that the taxpayer became the sole shareholder of Holsey. The Tax Court sustained the Commissioner's ruling that Holsey's purchase of the outstanding stock for $80,000 (taxpayer had initially purchased a 50% interest in Holsey for $11,000) was "essentially equivalent to the distribution of a taxable dividend to the taxpayer." The Third Circuit disagreed with this assessment, holding that the indirect benefit inuring to the taxpayer (he now "had 100% of the outstanding stock and the Greenville Company none") "could not give rise to taxable income . . . until the corporation makes a distribution to the taxpayer or his stock is sold." Finding no "direct pecuniary benefit to the taxpayer" resulting to the taxpayer as a consequence of this transaction, the Court held "the Tax Court erred in holding the distribution in question taxable to him."

In Niederkrome v. C. I. R., 266 F.2d 238 (9th Cir. 1958) cert. denied, 359 U. S. 945, 79 S.Ct. 725, 3 L.Ed.2d 678 (1959), this court, in dictum, approved the reasoning of *Holsey*.

The Graves argue that Challenger's rental payments constituted contributions to capital, as provided for in Section 362(c), to its sister corporation. Because the Challenger "benefited from the use to which the recipients put the rentals" (paying the bank loan and taxes which Challenger would have had to pay had it purchased the lots), the Graves maintain this case comes within the purview of the rule that capital contributions to a corporation by a non-shareholder arise when he receives a reciprocal benefit therefrom. Brown Shoe Co., Inc., v. C. I. R., 339 U.S. 583, 70 S.Ct. 820, 94 L.Ed. 1081 (1950); Edwards v. Cuba Railroad Co., 268 U.S. 628, 45 S.Ct. 614, 69 L.Ed. 1124 (1925).

The argument propounded by the Graves does not, in our view, appreciate the significant differences between the case at bar and those upon which they rely. In *Holsey* and *Niederkrome*, the courts were impressed with the fact that an "economic or financial advantage" was not determinable merely by securing corporate control. Although they acknowledged that there was a real possibility that such "advantages" would flow as a result of this control, the courts were hesitant to declare that this was an *ipso facto consequence*. As noted by this court, the profits gained from the sale of these shares were taxable, as well as any surplus which might accumulate during the years. In sum, the courts saw no need to engage in financial speculation, when the shareholders remained bound to the taxman when their gains from the transactions were actually realized.

By contrast, the Graves *have* obtained immediate benefits from this leasing agreement. The nature of these benefits was summarized by the Tax Court:

> "Similarly, when he [R. L. Graves] established the rental to be paid to Sparks Development for the use

of the Parking Lots, it was set high enough to provide the funds necessary to pay off the obligations incurred in the purchase of the Parking Lots. Had the rentals been set at a lower figure—at the amount which would have been paid in the market place for the rental of such Parking Lots, it would have been necessary for Sparks Development to have secured additional capital in some other manner, for example, by contributions from Mr. Graves. In other words, as a result of the payment of excessive rentals, the equity in Sparks Development . . . was increased, and when the Challenger stock was sold to the Ascuagas, the Graves were left with [a] valuable corporation, Sparks Development. . . ."

The arrangement devised by R. L. Graves is similar to one recently condemned by the Fifth Circuit. In Sammons v. United States, 433 F.2d 728 (5th Cir. 1970), the taxpayer received a constructive dividend as a result of transferring stock between corporations which he either controlled or owned outright. The pertinent facts are these: American Republic, a corporation indirectly controlled by the taxpayer, purchased the fixed assets of Atlanta Fulton while the other assets were acquired by Texas Fulton, which was owned by five corporations controlled by the taxpayers. The fixed assets were then leased by American Republic to Texas Fulton which commenced the operation of the multibag business heretofore operated by Atlanta Fulton.

Thereafter, the five corporations already denoted sold their Texas Fulton stock at cost to Fidelity National, another of the taxpayer's corporations. Fidelity then sold its Texas Fulton stock to Westvaco and made a profit of $556,000.

The jury found that Fidelity National received a bargain purchase from its "brother" corporations in that the fair market value of Texas Fulton was greater than the amount

paid by Fidelity National. Specifically, the jury found that the stock was worth $500,000 more than Fidelity National had paid, thus leaving the taxpayer liable for taxes on this sum as a constructive dividend. The Fifth Circuit upheld the District Court's approval of the jury's finding:

> "In conclusion, we hold that Mr. Sammons received a constructive dividend when he moved the paper bag business between wholly-owned or controlled corporate entities at a price which the jury reasonably concluded to be one-half million dollars below fair market value. In reality then, the taxpayer took money from his five corporations and placed it in a sixth. It is of little consequence that he personally received no money from the transaction, for it is the power to dispose of income and the exercise of that power that determines whether taxable income has been received."
> Sammons v. United States, supra.

Similarly, we find no merit in the contention that Challenger's excessive rental payments can be viewed as contributions to capital. As indicated by the Tax Court, there is no evidentiary basis to support such a proposition because no benefit flowed to Challenger as a result therefrom:

> "Challenger could expect no benefit to itself from the payment of the excessive rentals. Indeed, . . . Challenger derived no benefit from the fact that its excessive rentals enabled Sparks Development to pay off quickly the loans incurred in purchasing the Parking Lots. It seems altogther clear that if Challenger had been independent from control by the Graves, it would have had no reason to make capital contributions to [a corporation] which received the excessive rentals. They were paid because Mr. Graves willed it so, not because Challenger benefited thereby."

In March of 1955, Challenger leased 100 slot machines from Pub, Inc., Saratoga Club, Inc., and United Waldorf

Inc., three corporations wholly owned by the Graves. This lease continued in effect with terms unchanged until October 1, 1960, when the machines were sold to Challenger for $200 per machine. In accordance with the terms of the lease, Challenger paid these corporations $97,336.07 and $103,821.15 respectively, for the taxable years 1959 and 1960. In Challenger, Inc., 23 TCM 2096 (1964), the Tax Court held that the reasonable rental value of the slot machines did not exceed $2.59 per machine per month for the taxable years 1955 through 1958. Accordingly, the Tax Court sustained the Commissioner's disallowance as rental deduction those amounts which exceeded the machines' true value. The Tax Court below held that by virtue of this prior decision against their wholly-owned corporation, Challenger, the Graves were collaterally estopped from relitigating the reasonable rental value of the slot machines for the years 1959 and 1960. As a consequence thereof, the Graves were charged with constructive dividends for those portions of the rental payments which exceeded the reasonable rental value of the slot machines.

R. L. Graves has challenged the Tax Court's application of collateral estoppel, maintaining in part, that his status of Challenger's controlling shareholder is not a basis upon which privity may be established. The nature of this challenge has long troubled the courts. Read in broad terms, there are a host of decisions which support or reject the view advanced by this taxpayer.[3] Confronted with this Solomon-like task, we have found most persuasive the common-sense reasoning set forth by Professor Moore: "It would seem that the public policy underlying the doctrine

3. See generally, Foreign & Domestic Music Corp. v. Licht, 196 F.2d 627 (2d Cir. 1952); Hornstein v. Kramer Bros. Freight Lines, 133 F.2d 143 (3rd Cir. 1943). By contrast, see generally, In Re Shea's Will, 309 N.Y. 605, 132 N.E.2d 864 (1956); D. Bruce Forrester, 4 T.C. 907 (1945).

of res judicata, as a bar to repetitious litigation, would support a finding of privity between a close corporation and its sole or controlling stockholder." 1B Moore's Federal Practice (2d ed.), par. 0.422[3].

Given the establishment of the Graves privity[4] with Challenger, we are satisfied that the Tax Court's invocation of the collateral estoppel doctrine was entirely appropriate. As indicated, the Tax Court's decision in *Challenger* set forth the reasonable rental value of the slot machines. In the interim between that decision and the one now in controversy, nothing has occurred regarding relevant facts or principles of law which could be deemed of such significance to deny application of the doctrine. Accordingly, we find no error in the Tax Court's finding of constructive dividend with regard to the unreasonable portions of rent paid for the use of the slot machines.[5]

Affirmed.

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4. Flora Graves asserts that collateral estoppel cannot be applied to her because title in the Challenger's stock was in the name of her husband, R. L. Graves. Because Nevada is a community property state (see Nev.Rev.Stat., §§ 123.220, 123.225) we must disagree with this assertion. As the owner of one-half the community, Mrs. Graves had an equal interest with her husband in the Challenger stock. For this reason, we believe it reasonable to apply the reasoning of Professor Moore to such an interest.

5. In so finding, we adopt the Tax Court's analysis rejecting the contention these payments constituted contribution to capital: "Challenger could expect no benefit to itself from the payment of the excessive rentals. Indeed, it could have purchasd the slot machines with the amounts it paid each year for the rentals . . ."

Appendix C

Filed Sep 11 1972

United States Court of Appeals
for the Ninth Circuit

No. 26504

SPARKS NUGGET, INC., as Transferee, R. L. GRAVES, et al.,
Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellee.

ORDER

Before: ELY and CHOY, Circuit Judges, and
BYRNE, District Judge.*

The Petition for Rehearing is denied.

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*Honorable William M. Byrne, Sr., Senior United States District Judge, Los Angeles, California, sitting by designation.

Appendix D

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

United States Constitution:

Amendment V

No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

Amendment XVI [1913]

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

Internal Revenue Code of 1954:

26 U.S.C. § 61. Gross income defined

(a) General definition—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

....

26 U.S.C. § 162. Trade or business expenses

(a) In general—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

For purposes of the preceding sentence, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State, congres-

sional district, Territory, or possession which he represents in Congress shall be considered his home, but amounts expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes in excess of $3,000.

....

26 U.S.C. § 482. Allocation of income and deductions among taxpayers

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organization, trades, or businesses.

Appendix E

T.C. Memo. 1964-338

United States Tax Court

THE CHALLENGER, INC.[1] v. COMMISSIONER OF INTERNAL REVENUE

Memorandum Findings of Fact and Opinion

TRAIN, Judge: Respondent determined deficiencies in income taxes as follows:

	FY Ended	Amount
The Challenger, Inc., Docket No. 88427..	9-30-55	$30,986.51
	9-30-56	81,023.31
	9-30-57	59,403.42
	9-30-58	59,134.26
The Pub, Inc., Docket No. 90743	8-31-57	9,859.20
	8-31-58	5,462.79
	8-31-59	9,184.80
Saratoga Club, Inc., Docket No. 90744....	10-31-56	6,162.58
	10-31-57	6,142.46
	10-31-58	5,589.18
	10-31-59	8,899.71
Caldwell Sport Shop, Inc., Docket No. 90745	5-31-59	6,944.94
United Waldorf, Inc., Docket No. 90746..	6-30-56	5,355.83
	6-30-57	6,856.93
	6-30-58	5,742.60
	6-30-59	8,986.65

By amended petitions in docket Nos. 90743 through 90746, the petitioners therein claim overpayments as follows:

	FY Ended	Amount
The Pub, Inc., Docket No. 90743	8-31-57	$ 2,723.54
	8-31-58	13,340.79
	8-31-59	22,233.93
Saratoga Club, Inc., Docket No. 90744....	10-31-56	8,949.95
	10-31-57	8,495.33
	10-31-58	7,690.70
	10-31-59	13,014.84

1. Proceedings of the following petitioners are consolidated herewith: Carson City Nugget, Inc., Docket No. 90742; The Pub, Inc., Docket No. 90743; Saratoga Club, Inc., Docket No. 90744; Caldwell Sport Shop, Inc., Docket No. 90745; and United Waldorf, Inc., Docket No. 90746.

	FY Ended	Amount
Caldwell Sport Shop, Inc., Docket No. 90745	5-31-59	$ 1,950.00
United Waldorf Inc., Docket No. 90746..	6-30-56	11,874.78
	6-30-57	6,549.07
	6-30-58	8,560.54
	6-30-59	13,085.61

Respondent determined deficiencies in income taxes of Twin Falls Brunswick, Inc., as follows:

FY Ended	Amount
8-31-55	$30,256.54
8-31-56	43,538.24
Period 9-1-56 to 5-31-57	196.12

Respondent further gave notice that Carson City Nugget, Inc., docket No. 90742, was liable as transferee for the entire deficiencies of Twin Falls Brunswick, Inc. Carson City Nugget, Inc., first admitted, but by amended petition denied, its asserted transferee status. That issue has been severed for trial at a later date if we should hold that there are deficiencies in income taxes of Twin Falls Brunswick, Inc. The above-listed dockets have been consolidated for trial and briefing as to all other issues.

The issues remaining for decision are:

1. Whether respondent properly allocated to the Challenger certain slot machine income reported as rent income by the Pub, Saratoga, and Waldorf and deducted as rent expense by the Challenger;

2. If so, whether the taxable incomes of the Pub, Saratoga, and Waldorf should be reduced by the amounts allocated to the Challenger;

3. Whether the Pub, Saratoga, and Waldorf are entitled to surtax exemption;[2]

4. Whether respondent properly disallowed portions of the rent deductions taken by the Challenger and Nugget Enterprises with regard to realty leased by them;

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2. At trial, respondent conceded error in denying the surtax exemption to Caldwell, Docket No. 90745.

5. Whether respondent properly disallowed a portion of the rent deductions taken by Twin Falls with regard to realty leased by it from Caldwell and, if so, whether such receipts are includible in Caldwell's income;

6. Whether respondent properly disallowed a portion of the rent deductions taken by Twin Falls with regard to realty leased by it from Waldorf and, if so, whether such receipts are includible in Waldorf's income; and

7. Whether respondent properly disallowed a portion of the rent deductions taken by Twin Falls with regard to property acquired by it under leases.

....

Opinion

Issue 1.

Slot Machine Rent—Deductions

In the deficiency notice to the Challenger, respondent described the adjustment here at issue as "Reallocated income and deductions." In the "*EXPLANATION OF ADJUSTMENTS*" section of the deficiency notice, respondent set forth his reliance upon sections 61, 269, and 482.[3] No mention was made of section 162(a).[4] In his answer,

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3. All statutory references are to the Internal Revenue Code of 1954 unless indicated otherwise.

SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such oganizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

4. SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the tax-

respondent admitted that he was disallowing the Challenger's slot machine rent deduction "through the form of allocating to and taxing to the petitioner the income of those corporations," *i.e.*, the Pub, Saratoga, and Waldorf. In his opening statement respondent's counsel stated that "The case is somewhat complicated by a more sophisticated approach taken in the ninety day letter, that of imputing the income to The Challenger." His view at trial was that the Challenger's slot machine rent payments to the Pub, Saratoga, and Waldorf were not deductible because not ordinary or necessary. On brief, respondent argues that the payments were unreasonable and not ordinary or necessary business expenses and, alternatively, that the deduction may be disallowed under section 482.

Petitioners assert that the slot machine rent arrangements were entered into for business, not tax avoidance, purposes and that the terms of the slot machine leases were fair.

We agree in large part with respondent.

A *prima facie* case for rent deduction may normally be made out through persuasive evidence that the property in question was used in the taxpayer's trade or business and that the disputed payments were made pursuant to an effective lease of that property. *Anderson Dairy, Inc.* 39 T. C. 1027, 1043-1044 (1963), on appeal C. A. 9, September 11, 1963. See *Sprague Electric Co.*, 36 T. C. 1043, 1083 (1961); *Leon Papineau*, 28 T. C. 54, 57 (1957). However, when lessor and lessee are owned by the same individual and respondent

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able year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

• • •

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

has determined the "rent" to be unreasonable, then the lessee must go further in order to carry its burden of persuading us that the amounts paid were really intended to be rent. *Roland P. Place,* 17 T. C. 199, 203 (1951), and cases there cited, affd. 199 F.2d 373 (C.A. 6, 1952); *Utter-McKinley Mortuaries v. Commissioner,* 225 F. 2d 870, 872-873 (C. A. 9, 1955), affirming a Memorandum Opinion of this Court dated July 17, 1953; *J. J. Kirk, Inc.,* 34 T. C. 130, 137 (1960), affd. 289 F. 2d 935 (C. A. 6, 1961). Also, when respondent has determined that an allocation of income or deductions is necessary in order to prevent evasion of taxes or clearly to reflect the incomes of the relevant entities, then such determination may not be set aside unless it is shown to be arbitrary and unreasonable. *Nat Harrison Associates, Inc.,* 42 T. C. 601, 621 (1964); *Grenada Industries, Inc.,* 17 T. C. 231, 255 (1951), affd. 202 F. 2d 873 (C. A. 5, 1953); *National Securities Corporation,* 46 B. T. A. 562, 565 (1942), affd. 137 F. 2d 600, 602 (C. A. 3, 1943).

Without incurring any of the usual obligations of a slot machine lessor, except for the $12,500 cost of the machines, the Pub, Saratoga, and Waldorf received more than $420,000 during 4½ years. The leases could be cancelled on thirty-days' notice. Nevertheless, the Challenger continued the leases on terms substantially unfavorable to itself.[5] See

5. Q. Did the time come when the Challenger was in financial position to buy the slot machines which originally it had leased in 1955 from the three corporations?

A. [Graves] Yes; I suppose somewhere along the line that time came.

Q. Were these agreements terminated, and did the Challenger at any time in the taxable years here involved buy these machines?

A. No.

Q. And why did it not terminate the leases and buy the machines?

A. Well, we can—I believe it was just because we considered a deal a deal. The deal was made and it had been working out, the arrangements were satisfactory, and I just went along with it.

Warren Brekke, 40 T. C. 789, 800 (1963), on appeal, C. A. 9, March 24, 1964.

Petitioners introduced schedules purporting to show that the Challenger received as much net income under the slot machine leases as it would have received under the usual 50-50 arrangement. There also was testimony to the effect that a slot machine lessor would normally expect to receive, after payment of license fees and costs of repair and maintenance, 15 to 20 percent of the net. If a 50 percent net profit is standard for a casino owner who takes no risk of loss and is spared the burdens of maintaining, repairing, and procuring licenses for the machines, we fail to believe that a casino owner who has assumed such burdens would be satisfied with such a net profit. And if 15 to 20 percent is standard net profit to a slot machine lessor who has assumed the risks and burdens, we find it difficult to believe that an arm's length negotiation could produce such a profit to a lessor who did not assume such risks and burdens. See *Mandel Brothers*, 4 B. T. A. 341, 353 (1926). No convincing explanation has been given for such uneconomic behavior.

Petitioners' expert witness testified that in his opinion the Challenger's slot machine leases were reasonable. However, he conceded that he had not, in twenty years of leasing slot machines, entered into such an arrangement. His own testimony about the leases he himself had entered into, the usual practice in slot machine leasing in Nevada at the time, and the propensity of large casinos to acquire their own machines all tend to contradict his opinion evidence on this point. Further, he conceded that he did not know or had only vague ideas about a number of the elements that he testified were necessary to a determination of the reasonableness of the leases. Under these circumstances, we decline to give great weight to his statement

that such a lease arrangement as we face here was reasonable. See *Tripp v. Commissioner,* ——F. 2d—— (64-2 USTC § 9804 at p. 94,086; C. A. 7, October 23, 1964), affirming a Memorandum Opinion of this Court.

We conclude, on the basis of our findings of fact, that some part of the amounts paid by these related parties under the slot machine rent agreements was not required to be paid for the use of the slot machines and that respondent did not err in determining that some part of the Challenger's rent deductions should be reallocated back from the other commonly controlled corporations in order clearly to reflect the income of each corporation. However, this determination does not dispose of the issue.

In the deficiency notice, respondent purported to allocate back to the Challenger its entire rent payments less the depreciation taken by the Pub, Saratoga, and Waldorf. In effect, respondent treated the Challenger as owner of the slot machines which in form were rented from the Pub, Saratoga, and Waldorf. This treatment conflicts with respondent's position with respect to Issue 3, which depends upon a valid transfer of the slot machines to the Pub, Saratoga, and Waldorf.

The record indicates that the latter three corporations owned the machines. Respondent does not suggest that the Challenger's payments under the lease constituted, in whole or in part, payments for the acquisition of an equity in the slot machines. That Graves may have been motivated by tax considerations to cause those corporations, rather than the Challenger, to own the slot machines may affect our view of the bona fides of the lease terms, but it does not, on the record in this case, change the fact of separate ownership. See *Seminole Flavor Co.*, 4 T. C. 1215, 1235 (1945) and cases there cited; *Buffalo Meter Co.*, 10 T. C. 83, 89 (1948); *Interior Securities Corp.*, 38 T. C. 330, 340

(1962); *John F. Nutt*, 39 T. C. 231, 248 (1962), on appeal, C. A. 9, July 11, 1963; *Nat Harrison Associates, Inc., supra*, at 620. Compare *Royal Farms Dairy Co.*, 40 T. C. 172 (1963), on appeal, C. A. 9, October 1, 1963, with *Warren Brekke, supra*, and *Catherine G. Armston*, 12 T. C. 539 (1949), affd. 188 F. 2d 531 (C. A. 5, 1951).

Since the Challenger needed the slot machines for use in its business and did not own the machines, some part of the amounts it paid would have been required to be paid as rent as a result of a hypothetical arm's length negotiation. Thus, our task is to determine what a reasonable rent would have been (*Royal Farms Dairy Co., supra*, at 189; *Potter Electric Signal and Manufacturing Co. v. Commissioner*, 286 F. 2d 200, 202, 204 (C. A. 8, 1961), affirming a Memorandum Opinion of this Court, *Limericks, Inc.*, 7 T. C. 1129, 1135 (1946), affd. 165 F. 2d 483 (C. A. 5, 1948)) or the extent to which the incomes of the Challenger and the other corporations were distorted by the slot machine lease arrangements. *Pauline W. Ach*, 42 T. C. 114, 126 (1964) on appeal, C. A. 6, August 10, 1964; *Nat Harrison Associates, Inc., supra*, at 618, 621-622.

We have been given almost no information which would bear directly on these questions. This omission is in part due to the fact that arrangements of this sort apparently were not made at arm's length. However, we must arrive at some result that can be expressed in monetary terms. *Nat Harrison Associates, Inc., supra*, at 622; *Pauline W. Ach, supra*, at 124. See *Helvering v. Taylor*, 293 U. S. 507, 515 (1935); *Cohan v. Commissioner*, 39 F. 2d 540, 542 (C. A. 2, 1930). The lessors of the slot machines assumed no obligations for maintenance, repair, the securing of licenses, and the like. Comparison of the costs for those items with the lessor's investments in the slot machines persuades us that, for the usual lessor, the cost of the slot machines is

the comparatively riskless part of his investment in the business. We have examined the record, including the amount respondent was willing to allow as depreciation on the slot machines. We conclude that a reasonable monthly rent under these circumstances was not more than $2.59 per slot machine. See Nevada Revised Statutes section 99.050 (1) (1957 revision, 1961 Supp.). Of course, the Challenger may not then be permitted to deduct depreciation on these machines.

We reach the same result on this issue on the weight of the evidence whether we proceed under respondent's original section 482 allocation of slot machine income or under respondent's later position that the rental expense is to be disallowed under section 162. Consequently, we need not decide petitioner's contention that respondent's shift in position caused a shift in the burden of proof.

With these modifications, on this issue we hold for respondent.

Issue 2.

Slot Machine Rental—Income

If respondent is treated as proceeding under section 482 in allocating slot machine income to the Challenger, then corresponding amounts reported as rent income by the Pub, Saratoga, and Waldorf[6] must be allocated away from those corporations. *South Lake Farms, Inc.*, 36 T. C. 1027, 1042 (1961), affd. 324 F. 2d 837 (C. A. 9, 1963); *Hawaiian Trust Company Limited v. United States*, 291 F.2d 761, 770 (C. A. 9, 1961); *Chicago & North Western Railway Co.*, 29 T. C.

6. The Pub, Saratoga, and Waldorf each reported income on fiscal years ending on dates different from those used by the Challenger. Since the "rent" accrued monthly and varied from month to month, the adjustment for any of the Challenger's taxable years would be different in amount from the adjustments for the other corporations' taxable years.

989, 999 (1958); *Hypotheck Land Co. v. Commissioner*, 200 F. 2d 390, 396 (C. A. 9, 1952), reversing on another point 16 T. C. 1268 (1951); *Hearst Corporation*, 14 T. C. 575, 577-578 (1950); *General Industries Corporation*, 35 B. T. A. 615, 617 (1937).

Respondent insists that his primary position in Issue 1 is that the rent payments are to be disallowed because they were not ordinary and necessary expenses of the Challenger's trade or business. Section 162(a) (3). Respondent has not determined that the payments resulted in receipts of any given category. He notes that the payments were received under a claim of right. He quotes from *Herbert Davis*, 26 T. C. 49, 56 (1956), to the effect that this Court need only determine if the payments were ordinary and necessary—if they were not, the deductions are disallowed and we need not determine what the payments were.

Petitioners maintain that, if the payments are not deductible by the Challenger, then the receipts cannot be income to the Pub, Saratoga, and Waldorf. They argue that respondent must lose on this point under section 482 and should not be permitted to avoid that result by now invoking section 162, at least not where the payor and payees are all before the Court in the same case. They maintain that "the nature of any excess payment is completely indeterminate: it could be a gift, a contribution to capital, or an erroneous allocation of one taxpayer's income to another." None of these alternatives, petitioners say, results in taxable income to the recipients.

We agree in general with petitioners.

Receipt under a claim of right is an important criterion when the issue is whether or not the taxpayer can retroactively erase the *receipt* from income. It is not relevant to the case before us, where we are concerned with a retro-

active change in the *character* of an amount that was admittedly received under a claim of right.

Herbert Davis, supra, involved only the lessee. Each of the categories of expenditure there (*supra*, at 56) suggested as being possible proper characterizations of the payments —"a gift, or a diversion of income, or * * * a sham"—would have resulted in the lessee being denied a deduction. It was unnecessary for us to proceed further and decide which type of nondeductible characterization should be affixed to the payments. Manifestly, where the recipients of the payments are also before us and the different possible characterizations would have different tax consequences to the recipients for years that are before us, we are not so free to cut short our examination. See *Royal Farms Dairy Co., supra*, at 188-189.

The Code limits deduction of compensation payments to "a reasonable allowance." Section 162(a)(1). Denial of deduction for an unreasonable compensation expenditure is compatible with a conclusion that the expenditure nevertheless constituted compensation. *Rochl Construction Co.*, 17 T. C. 1037, 1041 (1951); *Reynard Corporation*, 30 B. T. A. 451, 454 (1934).

We have often noted the difference in phraseology between paragraphs (1) and (3) of section 162(a). The Code does not limit the rent payment deduction to "a reasonable allowance" as in the case of salary or compensation. We have inferred from this difference that deduction for a "rent" payment for property used in the taxpayer's business but not owned by the taxpayer will be denied only if we conclude that the payment did not constitute rent. *Royal Farms Dairy Co., supra*, at 187-188; *Anderson Dairy, Inc., supra*, at 1043; *Potter Electric Signal and Manufacturing Co. v. Commissioner, supra*, at 202-203; *J. J. Kirk, Inc.*,

supra, at 139; *Roland P. Place, supra*, at 203; *Stanley Imerman*, 7 T. C. 1030, 1037 (1946).

We are left, then, with a conclusion that the Challenger paid to the Pub, Saratoga, and Waldorf amounts of money which were not in fact rents, even though all four corporations treated them as such. Our inquiry is now directed to the tax character, to the recipients, of those payments.

Graves acquired all of the Challenger's outstanding stock prior to the inception of the slot machine leases and continued to be the Challenger's sole shareholder throughout the period before us. It would be absurd to suggest that Graves was a straw man, merely a dummy titleholder of the Challenger's entire stock and that the latter was really owned by the Pub, Saratoga, and Waldorf. It follows that the slot machine "rent" payments were not dividend distributions from the Challenger to the three recipient corporations. Section 301(a). We note in this connection that respondent does not treat these payments as dividends, since he would include the entire slot machine receipts in the recipient corporations' incomes without allowance of the intercorporate dividends-received deduction. Section 243 (a).

Nor were these payments made to purchase the slot machines. Each year's payments were several times the stipulated fair market value of the slot machines. Once again, respondent seeks to include the entire receipts as ordinary income and makes no allowance for recoupment of basis or capital gains deduction.

Finally, the excess "rent" payments do not appear to be compensation. Indeed, respondent often stresses the absence of valuable consideration given by the Pub, Saratoga, and Waldorf for the payments under the leases.

Having rejected the taxpayers' original treatment of the Challenger's payments, we must reach a decision regarding

the taxable nature of the receipts that is compatible with our decision regarding payments in these consolidated cases. Compare *R. E. L. Finley,* 27 T. C. 413 (1956), affd. 255 F. 2d 128, 134 (C. A. 10, 1958) and *Ray H. Schulz,* 34 T. C. 235 (1960), affd. 294 F. 2d 52 (C. A. 9, 1961) with *Commissioner v. Greenspun,* 156 F. 2d 917 (C. A. 5, 1946), reversing a Memorandum Decision of this Court dated April 12, 1944, and *Zeunen Corporation v. United States,* 227 F. Supp. 952, 955 (D. Mich., 1964).

Our findings are consistent with a conclusion that either: (1) for purposes of tax law the excess payments were in some fashion a nullity, as suggested by petitioners, giving rise to neither deductions nor taxable income; (2) the excess payments constituted capital contributions by the Challenger to the other three corporations (See *Veterans Foundation,* 38 T. C. 66 (1962), affd. 317 F. 2d 456 (C. A. 10, 1963)); or (3) the excess payments constituted constructive dividends to Graves from the Challenger followed by constructive capital contributions by him to the other three corporations. See *Montgomery Engineering Company,* 230 F. Supp. 838, (D. N. J., 1964).

In any of these events the receipt by the three corporations of the excess payments would not constitute taxable income to those corporations. Section 118.

We conclude, in light of the entire record and our decision on Issue 1, that the slot machine receipts are more likely to have constituted one of the described categories of nontaxable receipts, rather than any form of taxable income.

The parties have stipulated the elements from which we may calculate the proper deductions for depreciation on the slot machines in the hands of the Pub, Saratoga, and Waldorf. We have determined, in connection with Issue 1, *supra,* what part of the Challenger's payments constituted rent. These agreements and determinations will be given

effect in the Rule 50 computation and there will be eliminated from the incomes of the Pub, Saratoga, and Waldorf those amounts which we have determined not to be rent.

Except to the extent indicated above, on this issue we hold for petitioners.

Issue 3.

Surtax Exemptions.

Respondent determined in the deficiency notices that, under sections 269, 482, and 1551, the Pub, Saratoga, and Waldorf were not entitled to surtax exemptions for the years before the Court because slot machine income had been diverted to those corporations from the Challenger in order to use those corporations' surtax exemptions.

(a) *Section 1551.*[7] Four elements must exist before a surtax exemption may be disallowed under this section:

1. a transfer of property other than money by a corporation to the taxpayer;

2. the transferee was created for the purpose of acquiring this property *or* the transferee was not actively engaged in business at the time of the acquisition;

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7. SEC. 1551. DISALLOWANCE OF SURTAX EXEMPTION AND ACCUMULATED EARNINGS CREDIT.

If any corporation transfers, on or after January 1, 1951, all or part of its property (other than money) to another corporation which was created for the purpose of acquiring such property or which was not actively engaged in business at the time of such acquisition, and if after such transfer the transferor corporation or its stockholders, or both, are in control of such transferee corporation during any part of the taxable year of such transferee corporation, then such transferee corporation shall not for such taxable year • • • be allowed • • • the $25,000 exemption from surtax provided in section 11(e) • • • unless such transferee corporation shall establish by the clear preponderance of the evidence that the securing of such exemption or credit was not a major purpose of such transfer. • • •

This provision was amended effective for years subsequent to those before the Court, by Public Law 88-272, section 235(b), and Public Law 85-866, section 205(a).

3. the transferor or its stockholders or both controlled the transferee during any part of the taxable years at issue; and

4. the transferee has failed to establish by the clear preponderance of the evidence that the securing of its surtax exemption was not a major purpose of the transaction.

In his opening statement, respondent's counsel described the surtax exemption disallowance solely by a parenthetical reference to it as "part of the respondent's sophisticated approach to the problem of the multiplicity of corporations," *i.e.*, the section 482 approach to Issue 1. On brief, respondent maintains that the Pub, Saratoga, and Waldorf were not actively engaged in business at the time of their acquisition of the slot machines. On reply brief, respondent adds that the Challenger transferred the slot machines to those three corporations.

Petitioners insist that the three corporations were not dormant prior to their acquisition of the slot machines; that the slot machines were not acquired by the three corporations from the Challenger; and that the acquisition was for business reasons.

We agree with respondent as to the Pub, but agree with petitioners as to Saratoga and Waldorf.

We have found that Kelley transferred the slot machines to Saratoga and Waldorf in satisfaction of obligations assumed by him in buying out their interests in Nugget, Inc. Kelley held no interest in either the Challenger, Saratoga, or Waldorf. Nothing in the record suggests that the Challenger ever acquired the machines and then turned them over to Saratoga and Waldorf. There is no suggestion that any other property was transferred to Saratoga or Waldorf in a manner relevant to section 1551. We conclude that the latter two corporations have shown that the first and

third requirements for disallowance under section 1551 have not been met. Since the disallowance requirements under section 1551 are cumulative (*Bush Hog Manufacturing Co., Inc.*, 42 T. C. 713, 726 (1964); *Hiawatha Home Builders, Inc.*, 36 T. C. 491 (1961)) and two requirements apply neither to Saratoga nor to Waldorf, section 1551 does not authorize disallowance of their surtax exemptions.

Kelley also transferred 40 slot machines to Caldwell, which in turn transferred them to the Pub. Graves' ownership of both Caldwell and the Pub causes the latter transfer to satisfy both the first and the third of the four requirements set forth above. The fact that the transfer took the form of a sale rather than a contribution to capital does not make section 1551 inapplicable. See *Hiawatha Home Builders, Inc., supra*, at 498.

From about 1951 until its entry into the Westerner Club, the Pub did not engage in business. The Pub's investment in the Westerner Club was bought out on January 17, 1955. The slot machine transfer from Caldwell to the Pub did not occur until February 1, 1955. We have concluded that the Pub was not actively engaged in business at the time that Caldwell transferred the slot machines to it. Accordingly, the second of the above-listed requirements for disallowance of the Pub's surtax exemption has also been satisfied.

The statute imposes upon the Pub the burden of establishing "by the clear preponderance of the evidence" that the securing of a surtax exemption was not "a major purpose" of the transfer of slot machines from Caldwell to the Pub. The only explanation advanced for this transfer was that Caldwell needed cash at that time and the Pub either had the cash or was about to receive it on account of the liquidation of its interest in the Westerner Club. Caldwell's need for the cash early in 1955 is supposed to have arisen

from its purchase of the Gabler Building in Carson City in May 1954. According to Graves' testimony, Caldwell had to make payments on the purchase price early in 1955. This explanation of the purpose for the transfer of slot machines on February 1, 1955, is effectively refuted by the Pub's and Caldwell's books, which show that (1) Caldwell loaned a total of $22,000 to the Challenger on January 10 and February 11, 1955, indicating that Caldwell did not need the $5,000 for which it sold the slot machines to the Pub; (2) the Pub paid out substantially all of its Westerner Club receipts on January 14 and 19, 1955, indicating that the Pub did not have enough remaining from the Westerner Club to pay for the slot machines; and (3) the Pub did not pay Caldwell for the slot machines until November 10, 1955. We do not believe Graves' explanation that he merely overlooked until November payment for a transfer whose only asserted justification was the provision of cash to the transferor the preceding spring.

As our findings show, from the time the Pub disposed of its Westerner Club interest until the formation of Nugget Enterprises, the Pub had no source of income other than the Challenger slot machine lease. On the other hand, Caldwell had income beginning June 1, 1954, from the rent it charged Twin Falls for the Gabler Building. At the time of Caldwell's transfer of slot machines to the Pub, it could have been expected that more of the slot machine rent would have been subject to surtax exemption in the Pub's hands than in Caldwell's hands.

The Pub has failed to prove the absence of a major purpose to secure surtax exemption. *Cf. Marne S. Wilson*, 42 T. C. 914, 923-925 (1964). Consequently, all four disallowance requirements under section 1551 have been met as regards the Pub.

We hold that respondent correctly disallowed under section 1551 the surtax exemption of the Pub, but not those of Saratoga and Waldorf.

(b) Section 269.[8] On reply brief, respondent states his position:

> That the revival of dormant corporations for use in entirely different circumstances with funds borrowed from related entities, as was done here, is the equivalent of the "acquisition" of the corporations under section 269 of the Internal Revenue Code of 1954.

Petitioners argue that: the principal purpose of the slot machine acquisition and lease arrangement was "to start a casino with limited resources, and no one was looking ahead to income tax savings;" section 269(a)(2) does not apply because the slot machines were acquired by purchase and so there was no carryover basis; Graves' acquisition of control of the corporations long antedated the slot ma-

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8. SEC. 269. ACQUISITIONS MADE TO EVADE OR AVOID INCOME TAX.

(a) In General.—If—

(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled directly or indirectly, immediately before such acquisitions, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

This provision was amended effective for years subsequent to those before the Court by Public Law 88-272, section 235(c)(2).

chine arrangements and so clearly could not have been motivated by a principal purpose to avoid taxes by improper use of those arrangements; the corporations were not dormant prior to the slot machine leases; and a revival of a dormant corporation is not equivalent to an "acquisition" under section 269.

We agree with petitioners' reading of section 269.

Respondent's statement of position indicates his reliance upon paragraph (1), rather than paragraph (2), of section 269(a).

Section 269(a)(1) requires acquisition of "control," not acquisition of the corporation. Congress undertook to define "control" for these purposes in terms of stock ownership. See *Pauline W. Ach, supra,* at 128. The revival of a dormant corporation does not constitute the acquisition of ownership of stock.

Section 269 is essentially a re-enactment of section 129 of the Internal Revenue Code of 1939, added by section 128 of the Revenue Act of 1943. The Senate Finance Committee Report stated (Sen. Rept. 627, 78th Cong., 1st Sess., 1943, p. 60):

> Control once acquired could not be again acquired, unless the group was in some way broken. A mere shift in the form of control—from direct to indirect, from indirect to direct, or from one form of indirect to another form of indirect—cannot, therefore, amount to acquisition of control within the meaning of [section 129].

Since Graves owned the requisite percentage of shares to constitute control before the corporations entered Nevada, and this control was not broken prior to the transfer of slot machines, there could not have been an *acquisition* of control when the corporations entered into the slot machine arrangements.

Respondent would require us to determine when a corporation is deemed "dormant" and when it is "revived" within the meaning of section 269. Of course, neither word appears in the section. Respondent does not assist our effort to define these terms. Involvement in slot machine leases with the Challenger does not appear to be such a change in level of activities that it would satisfy any reasonable definition of respondent's "revival of dormant corporations" test.

Respondent notes that we have held that section 269 authorizes disallowance of tax benefits to acquired as well as acquiring corporations and that incorporation will constitute an acquisition of control under section 269. He invites us to extend these decisions further and rule that revival will also constitute such an acquisition. In the cases referred to by respondent, *Commissioner v. British Motor Car Distributors, Ltd.*, 278 F. 2d 392 (C. A. 9, 1960), and *James Realty Company v. United States*, 280 F. 2d 394 (C. A. 8, 1960), the taxpayers had control (as defined in the *statute*) of corporations after the acquisitions and did not have control, as so defined, before the acquisitions. Here, Graves controlled the corporations before the slot machine arrangements and controlled the same corporations after the arrangements were entered into. Those cases relied upon by respondent thus differ from this one in a way that the statute makes decisive.

The deficiency notices, opening statement, and reply brief make it clear that respondent is concerned in this issue with diversion of slot machine revenue from the Challenger to the other corporations. Our decision in Issue 1 transfers back to the Challenger substantially all of what respondent claimed was being diverted. Consequently, neither Graves nor petitioners have received a tax benefit from the slot machine arrangement. Section 269 is not an all-purpose provision. Even tax-motivated transactions must take cer-

tain forms before that provision can apply. See *John F. Nutt, supra,* at 250, *acq.* 1964-11 I. R. B. 5.

We hold that the surtax exemptions of Saratoga and Waldorf may not be disallowed under section 269.

(c) *Section 482.* Respondent contends that the "credits and allowances" which he may allocate under section 482 includes the surtax exemption. Petitioners dispute this understanding of section 482. They aver that in any event section 482 authorizes only allocations and that respondent has disallowed, but not allocated, the surtax exemptions.

We agree with petitioners.

The short answer to respondent's contention is that he has not allocated the surtax exemptions of Saratoga and Waldorf to some other organization, trade, or business, he has merely disallowed them. In contrast to sections 269 and 1551, section 482 does not authorize disallowances, it authorizes only distributions, apportionments, and allocations. See Issue 2, *supra.*

Respondent maintains that the predecessors of sections 482, 269, and 1551 "were to perform parallel functions in the frustration of tax avoidance schemes through application of the allocation power." He cites statements in several congressional committee reports indicating that those provisions were all expected to be useful in multiple corporation problems. We agree. Our recent decisions in *Hamburgers York Road, Inc.,* 41 T. C. 821 (1964), and *Bush Hog Manufacturing Co., Inc., supra,* illustrate the nature of this parallelism. Respondent argued in those cases that the entire taxable income of one corporate petitioner was properly taxable to the other corporate petitioner under section 482. Our agreement with this position in *Hamburgers York Road, Inc.,* made it unnecessary to reach respondent's alternative determination in that case, that one surtax exemption should be disallowed under sec-

tions 269(a) or 1551. 41 T. C. at 840. In *Bush Hog,* respondent's surtax exemption argument under sections 269 and 1551 was clearly presented as an alternative to his effort to reallocate income under section 482. 42 T. C. at 724, 725.

Here respondent has reallocated to the Challenger only part of the income of the slot machine rental recipients. We have upheld that determination almost in entirety. To the extent that this reallocation reduced the recipients' incomes below $25,000, it reduced the value of their surtax exemptions. That is the extent to which respondent can achieve his intended results under section 482. Our incidental comments in *Kessmar Construction Co.,* 39 T. C. 778, 796 (1963), affd. 336 F.2d 865 (C. A. 9, 1964), in which respondent made substantially the same arguments that he makes here, were intended to recognize the fact that a reallocation of all net income from one profitable corporation to another under section 482 may accomplish the same monetary result as a disallowance of surtax exemptions under section 269. Those comments were not intended to indicate that section 482 may be authority for direct disallowance of a surtax exemption.

Respondent contends, further, that since the Challenger, the Pub, Saratoga, and Waldorf "are in reality one entity they are entitled to but one surtax exemption." This view that the latter three corporations are not separate taxable entities is obviously inconsistent with respondent's effort, in this very issue, to increase the tax liabilities of each of those three corporations. See *Hamburgers York Road, Inc., supra; Nat Harrison Associates, Inc., supra,* at 618. We hold that respondent is without power to disallow surtax exemptions under section 482.

On this issue, we conclude that respondent properly disallowed the Pub's surtax exemption under section 1551. We uphold Saratoga and Waldorf as to their surtax exemptions.

Issue 4.

Rent: Challenger, Nugget Enterprises

On May 1, 1957, the Graves Children Trust No. 1 leased certain land in Sparks, Nevada, to the Challenger for ten years. Rent was fixed at $2,500 per month ($30,000 per year) for the first year and was then to be renegotiated. On September 23, 1957, that lease was canceled and the Graves Children Trust No. 1 leased the same land to Nugget Enterprises for twenty years at $3,750 per month ($45,000 per year) for the first five years. Nugget Enterprises immediately subleased this land to the Challenger for ten years at $3,750 per month for seven months and $15,000 per month ($180,000 per year) thereafter. Nugget Enterprises spent almost $800,000 on the construction of a building on that property, which building was completed on May 12, 1958, nineteen days after the $15,000 per month sublease rental went into effect.

Respondent determined that a fair rental payment by Nugget Enterprises for 1958 and by the Challenger for its taxable year ending September 30, 1958, would be $30,000 and in each case disallowed $15,000 of the rental deduction. On brief, respondent insists that the rents paid were excessive.[9] He states that, "The rent of a net of $11,250 a month, or $135,000 per year, to Nugget Enterprises, which the adjustments here would leave it, is a 17 percent return on the improvements of $796,000 and certainly fair and reasonable." Petitioners challenge respondent's authority to disallow deductions even for unreasonable rents "if they are in fact rents" and they maintain that the rents here in question were in fact reasonable.

9. Respondent does not suggest that the property was not used in the Challenger's or Nugget Enterprises' trade or business nor does he suggest that either of these entities had title to or equity in the property. His allowance of part of the rent deductions of both the Challenger and Nugget Enterprises constitutes an implicit concession that these requirements for deductibility have been met.

The lease and sublease required Nugget Enterprises and the Challenger to pay the amounts deduction of which is here at issue. See *Anderson Dairy, Inc., Sprague Electric Co.,* and *Leon Papineau,* all *supra.* Nugget Enterprises constructed on the leased property a new casino for the Challenger's use. These matters having been established, the close relationship of the lessor, lessee-sublessor, and sublessee require that we examine the reasonableness of the lease arrangements. The relationship does not require us to disregard the lease terms if we find those terms to be reasonable. *E.g., Jos. N. Neel Co.* [20,516], 22 T. C. 1083, 1090 (1954); *John F. Nutt, supra,* at 248.

Petitioners' expert testified that a reasonable rent for the improved property during the period before us on this issue was $350,869 per year and for the same property unimproved was $72,000 per year. Respondent answers that the expert admitted there were no comparable properties in Sparks and that all the leases that the expert considered relevant were of Reno properties. Respondent urges that the differences between Reno and Sparks are such that no weight can be given to an effort to derive fair rental value in Sparks from downtown Reno statistics. However, the expert realized this difficulty and noted that his estimate of fair rent for the unimproved property was approximately one-fifteenth the prevailing rate per square foot for similar Reno properties. His estimate of fair rent for the property as improved by the *sublessor* was one-third the prevailing rate for Reno properties improved by the ultimate *lessees* and used as the Challenger used its premises.

Respondent apparently concedes that the Challenger may properly deduct as rent amounts far in excess of the $30,000 per year deemed reasonable in the deficiency notice, since he states that a *net* rent of $135,000 per year is reasonable for the property in Nugget Enterprises' hands. Further

respondent's comment in his original brief that his adjustments would leave Nugget Enterprises with a net rent of $11,250 a month implies that if we uphold respondent's disallowance of part of the Challenger's rent deduction, then such amount is not to be included in Nugget Enterprises' income.[10] However, on reply brief, respondent denies any intention of allowing the payee of a disallowed rental to exclude the disallowed amount from its income. Respondent insists that such an exclusion could occur only if the disallowance were based upon section 482 and not upon section 162. See Issue 2, *supra,* and 5 and 6, *infra.* The interplay of the deficiency notices, the stipulated leases, and respondent's briefs leaves us with doubt as to what respondent's exact position is and as to whether respondent made any meaningful factual determination to which a presumption of correctness could attach.

Respondent offered no rebuttal evidence nor has he shown any sufficiently substantial defects in the expert's testimony. Even without respondent's adjustments, Nugget Enterprises would have a net rent of $135,000 per year—$180,000 per year receipt from the Challenger minus $45,000 per year payment to the Graves Children Trust No. 1. Assuming, despite our expressed doubts as to the vitality for this issue of any presumption of correctness, that petitioners have the burden of proving the reasonableness of the rental payments we conclude on the record before us that they have sustained this burden. See *American Metal Products Corp.,* 34 T. C. 89, 105-106 (1960), affd. 287 F. 2d 860 (C. A. 8, 1961).

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10. Nugget Enterprises received $15,000 per month. If it may deduct only $2,500 per month of its payments to the Trust, per respondent's determination, then its net rental income would be $12,500 per month. It would appear that respondent's $11,250 per month was arrived at by reducing the Nugget Enterprises' $12,500 net by the amount of the disallowance applicable to the Challenger —$1,250 per month.

In view of the facts that the rent payments were required by the September 1957 lease, that the cancellation of the May 1957 lease served the Challenger's business needs in that it facilitated the construction of a new casino for the Challenger (*cf. Ray's Clothes, Inc.*, 22 T. C. 1332, 1340 (1954); *Consolidated Apparel Co. v. Commissioner*, 207 F. 2d 580 (C. A. 7, 1953), reversing on this point, 17 T. C. 1570 (1952)), and that the rent paid did not exceed a reasonable rent for that property, petitioners have shown that they are entitled to deduct the amounts claimed in this issue.

On this issue we hold for petitioners.

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Appendix F

Treasury Regulation Section 1.482-2(c)

(c) Use of tangible property—(1) General rule. Where possession, use, or occupancy of tangible property owned or leased by one member of a group of controlled entities (referred to in this paragraph as the owner) is transferred by lease or other arrangement to another member of such group (referred to in this paragraph as the user) without charge or at a charge which is not equal to an arm's length rental charge (as defined in subdivision (i) of subparagraph (2) of this paragraph), the district director may make appropriate allocations to properly reflect such arm's length charge. Where possession, use, or occupancy of only a portion of such property is transferred, the determination of the arm's length charge and the allocation shall be made with reference to the portion transferred.

(2) Arm's length charge. (i) For the purposes of this paragraph, an arm's length rental charge shall be the amount of rent which was charged, or would have been charged for the use of the same or similar property, during the time it was in use, in independent transactions with or between unrelated parties under similar circumstances considering the period and location of the use, the owner's investment in the property or rent paid for the property, expenses of maintaining the property, the type of property involved, its condition, and all other relevant facts. . . .

(ii) Except as otherwise provided in subdivision (iii) of this subparagraph the amount referred to in subdivision (i) of this subparagraph for the taxable year shall be equal to the sum of the following amounts attributable to the property:

(a) The amount which bears the same ratio to the depreciable basis of the property divided by the total useful life of the property in the hands of the owner as the number of days which the property is owned by the owner (in the taxable year) bears to 365. . . .

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(b) The amount which bears the same ratio to 3 percent of the depreciable basis of the property (as determined in subdivision (ii)*(a)* of this subparagraph) as the number of days which the property is owned by the owner (in the taxable year) bears to 365.

(c) The amount of all expenses directly and indirectly connected with the property paid or accrued by the owner of the property during the taxable year. Such expenses include real estate, personal property, or other taxes on the property, expenses of maintenance and repair, cost of utilities, management expenses, and other similar expenses. Such amount does not include interest expense.

(d) ....

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes involved	2
Statement	2
Argument	5
Conclusion	10
Appendix	11

CITATIONS

Cases:

B. Forman Co. v. *Commissioner*, 453 F. 2d 1144, certiorari denied, 407 U.S. 934	8
Biltmore Homes, Inc. v. *Commissioner*, 288 F. 2d 336, certiorari denied, 368 U.S. 825	6
Brown Printing Co. v. *Commissioner*, 255 F. 2d 436	8
Challenger, Inc. v. *Commissioner*, 23 T.C.M. 2096	4
Clark v. *Commissioner*, 266 F. 2d 698	5
Commissioner v. *First Security Bank of Utah*, 405 U.S. 394	8
Holsey v. *Commissioner*, 258 F. 2d 865	7
Limericks, Inc. v. *Commissioner*, 165 F. 2d 483	5
Midland Ford Tractor Co. v. *Commissioner*, 277 F. 2d 111	8
Rubin v. *Commissioner*, 429 F. 2d 650, on remand, 56 T.C. 1155, affirmed *per curiam*, 460 F. 2d 1216	7, 8
Sachs v. *Commissioner*, 277 F. 2d 879, certiorari denied, 364 U.S. 833	5
Sammons v. *United States*, 433 F. 2d 728, certiorari denied, 402 U.S. 945	6, 9
Southeastern Canteen Co. v. *Commissioner*, 410 F. 2d 615	8
Tennessee-Arkansas Gravel Co. v. *Commissioner*, 112 F. 2d 508	8
Waldheim v. *Commissioner*, 244 F. 2d 1	5
Worcester v. *Commissioner*, 370 F. 2d 713	6

Page

Statutes and regulations:
Internal Revenue Code of 1954 (26 U.S.C.):
Sec. 61 ..... 2, 7, 8, 11
Sec. 162 ..... 2, 8, 9, 11
Sec. 301 ..... 2, 11
Sec. 301(c) 5
Sec. 316 ..... 2, 12
Sec. 316(a) 5
Sec. 482 ..... 2, 7, 8, 9, 13
Sec. 531 6
Treasury Regulations on Income Tax, § 1.61-1(b) (26 C.F.R.) 8

In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-810

R. L. GRAVES, FLORA J. GRAVES, R. L. AND FLORA J. GRAVES, AND SPARKS NUGGET, INC. AS TRANSFEREE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court (Pet. App. 1-47) is reported at 29 T.C.M. 318. The opinion of the court of appeals (Pet. App. 48-62) is reported at 458 F. 2d 631.

JURISDICTION

The judgment of the court of appeals was entered on April 6, 1972 (Pet. App. 48). A petition for rehearing was denied on September 11, 1972 (Pet. App. 63). The

petition for certiorari was filed on December 4, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the courts below correctly held that petitioners Flora J. Graves and R. L. Graves constructively received dividends when funds were transferred, under the guise of purported rental payments, from one of their wholly-owned corporations to others.

STATUTES INVOLVED

The relevant provisions of Sections 61, 162, 301, 316 and 482 of the Internal Revenue Code of 1954 are set forth in the Appendix, *infra,* pp. 11-13.

STATEMENT

Petitioners Flora J. Graves and R. L. Graves (the Graveses), at all relevant times prior to September 30, 1960, owned all the outstanding stock of The Challenger, Inc. The Graveses also owned all the stock of Sparks Development, Inc., during the years in issue. Petitioner Sparks Nugget, Inc., purchased all of the stock of The Challenger on September 30, 1960. Challenger was subsequently liquidated by Sparks Nugget, and the latter corporation is a party to this action only in its role as transferee of Challenger (Pet. App. 49-50).

a. *Rental of parking lots*

Challenger, in June of 1959, leased six and one-half lots located in Sparks, Nevada, from its sister corpora-

tion, Sparks Development. These lots were used by Challenger as parking lots in connection with its operation of a gambling casino known as the Sparks Nugget Casino (Pet. App. 48-49). The initial term of the lease was five years, and the rental was $9,400 per month for the first year and $8,000 monthly for the next four years. These rentals were determined by R. L. Graves, acting on behalf of both Challenger and Sparks Development, so as to provide the latter with sufficient income to pay his compensation, its income taxes, and its purchase obligations on the parking lots. During the taxable years 1959 and 1960, Challenger's parking lot rental expenditures totaled $37,000 and $107,200, respectively (Pet. App. 49-50).

The Commissioner, acting under Section 162 of the Internal Revenue Code of 1954, disallowed rental deductions claimed by Challenger with respect to its leasing of the parking lots to the extent the monthly payments exceeded $4,000 on the ground that the excess amounts were not ordinary and necessary business expenses. The Tax Court sustained his action, finding that the reasonable rental value of the parking lots did not exceed $4,000 per month (Pet. App. 17, 36-37). The court of appeals affirmed (Pet. App. 50-57).

b. *Rental of slot machines*

Challenger leased 100 slot machines from certain other corporations owned by the Graveses in 1955.[1] This lease continued in effect with terms unchanged

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[1] Specifically, the lessors of the slot machines were The Pub, Inc., United Waldorf, Inc., and Saratoga Club Inc. (Pet. App. 60-61).

until 1960 when Challenger purchased all the machines at a total cost of $20,000. Challenger paid its sister corporations $97,336.07 during 1959 and $103,821.15 during 1960 in accordance with the terms of the lease. Computed on a monthly basis, these figures resulted in a monthly rental per machine of $81.11 in 1959 and $86.52 in 1960 (Pet. App. 60-61). The Commissioner determined that amounts in excess of $2.59 per month per machine were not bona fide rental payments, and, accordingly, disallowed claimed deductions for such amounts. In *Challenger, Inc.* v. *Commissioner,* 23 T.C.M. 2096, the Tax Court held that the reasonable rental value of these same slot machines did not exceed $2.59 per machine per month for the taxable years 1955 through 1958. Consequently, the Tax Court here held that by virtue of this prior decision against their wholly-owned corporation, Challenger, the Graveses were collaterally estopped from relitigating the reasonable rental value of the slot machines for the years 1959 and 1960. The Ninth Circuit agreed with the Tax Court's application of collateral estoppel (Pet. App. 61-62).

c. *Constructive dividends to the Graveses*

The Commissioner determined that the amounts diverted by the Graveses from Challenger to their other corporations in the form of excessive rental payments for the parking lots and slot machines were taxable to them as a constructive dividend. Both courts below held that the Commissioner's action was warranted since the Graveses had realized an immediate economic benefit from the distribution of Challenger's

earnings (Pet. App. 58-59). It is this determination which petitioners challenge here.

ARGUMENT

The decision below is correct. There is no conflict or any other reason for further review by this Court.

1. Sections 301(c)(1) and 316(a) of the Internal Revenue Code of 1954 (Appendix, *infra*, pp. 11-12) provide that a distribution to a stockholder out of a corporation's earnings and profits constitutes a dividend, and that such a distribution is includable in the stockholder's gross income. But it has long been settled that there may be a constructive dividend to a stockholder even though there is no formal declaration and distribution of a dividend. See *Clark* v. *Commissioner*, 266 F. 2d 698 (C.A. 9). The test is whether there is a diminution in the earnings and profits of a corporation which inures to the benefit of a stockholder, in one form or another. Familiar examples of constructive dividend situations are cases in which there is a transfer of corporate assets to a stockholder for a price which is less than the property's fair market value (*Waldheim* v. *Commissioner*, 244 F. 2d 1 (C.A. 7)), or in which a corporation pays a stockholder's debt to a third party (*Sachs* v. *Commissioner*, 277 F. 2d 879 (C.A. 8), certiorari denied, 364 U.S. 833), or where a corporation makes rental payments to a stockholder for use of his property in excess of the reasonable rental value of the property (*Limericks, Inc.* v. *Commissioner*, 165 F. 2d 483 (C.A. 5)).

In the same regard, the courts have consistently held that a stockholder who causes one of his corporations to

transfer a portion of its assets to a second corporation, owned or controlled by him, gratuitously or for inadequate consideration, realizes dividend income in the amount of earnings thus diverted. See, *e.g.*, *Sammons* v. *United States*, 433 F. 2d 728 (C.A. 5), certiorari denied, 402 U.S. 945; *Biltmore Homes, Inc.* v. *Commissioner*, 288 F. 2d 336 (C.A. 4), certiorari denied, 368 U.S. 825; *Worcester* v. *Commissioner*, 370 F. 2d 713 (C.A. 1). In these situations the stockholder is economically benefited by the enrichment of his second corporation, just as he is by the payment of a debt which he owes to a third party.

Here, the Graveses, under the guise of purported rental payments, diverted funds from their highly successful casino corporation (Challenger) to other corporations which they owned. The economic benefit to the Graveses from such diversion, justifying the imposition of a constructive dividend by both courts below, is clear. First, Challenger, despite its history of continuous and large earnings, never paid any dividends (Pet. App. 16). By diverting Challenger's earnings to several of their other corporations, the Graveses avoided the possibility of Challenger having to pay the accumulated earnings tax imposed by Section 531 of the Code. In addition, by transferring Challenger's earnings to passive corporations, the Graveses put themselves in a position whereby they could obtain these earnings, at capital gains rather than dividend rates (without affecting the income-producing Challenger), by simply selling or liquidating the recipient corporations. Finally, as both courts below pointed

out (Pet. App. 58-59), as a result of the payment of excessive rentals, the Graveses were able to build up the equity in Sparks Development so that when Challenger was sold they were left with a valuable corporation.[3]

2. Petitioners erroneously assert conflict with *Rubin* v. *Commissioner*, 429 F. 2d 650 (C.A. 2) (Pet. 6-8). In *Rubin*, the Second Circuit criticized the Tax Court for relying on Section 61 of the Code, Appendix, *infra*, p. 11 (which defines gross income), and on "common law" doctrines of taxation in determining that payments made by one corporation to another on account of services rendered to it by the controlling shareholder of both corporations (purportedly as an employee of the second corporation) were taxable to the controlling shareholder since he rather than his corporation earned the income. The court of appeals held that the Tax Court should have proceeded on the basis of Section 482, Appendix, *infra*, p. 13 (which permits the Commissioner to allocate income among controlled entities in certain circumstances) and remanded the case for a determination under this statute. On remand, the Tax Court reached the same result under Section 482

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[3] Petitioners' contention (Pet. 14-16) that the decision of the court of appeals below conflicts with that of the Third Circuit in *Helsey* v. *Commissioner*, 258 F. 2d 865, is without merit. In *Helsey*, as the court of appeals noted (Pet. App. 58-59), the economic benefit to the shareholders was considered by the court to be too speculative to warrant the imposition of a constructive dividend. Moreover, in that case there was a certainty that the gains from the transactions involved would be subject to tax when actually realized. In contrast, the Graveses have sustained immediate benefit from the diversion of Challenger's earnings which gains would have escaped taxation but for the imposition of a constructive dividend.

as it had reached under Section 61 (56 T.C. 1155), and the court of appeals affirmed, *per curiam* (460 F. 2d 1216).

The court's holding in *Rubin* that application of Section 61 is inappropriate in cases where Section 482 is available is not inconsistent with the application of Section 162, Appendix, *infra*, p. 11, by both courts below. Sections 61 and 162 cannot be considered identical in breadth of scope. Section 61 is a catchall provision and is the broadest statute in the Code.[8] Section 162, on the other hand, pertains only to ordinary and necessary business expenses and is the specific statutory provision dealing with rental payments. Moreover, the decision of the Ninth Circuit below is in accord with numerous other decisions in which the courts have relied on Section 162 in determining whether rental payments between related parties were excessive. See, *e.g.*, *Southeastern Canteen Co.* v. *Commissioner*, 410 F. 2d 615 (C.A. 6); *Brown Printing Co.* v. *Commissioner*, 255 F. 2d 436 (C.A. 5); *Midland Ford Tractor Co.* v. *Commissioner*, 277 F. 2d 111 (C.A. 8).

Cases such as *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394, *B. Forman Co.* v. *Commissioner*, 453 F. 2d 1144 (C.A. 2), certiorari denied, 407 U.S. 934, and *Tennessee-Arkansas Gravel Co.* v. *Commissioner*, 112 F. 2d 508 (C.A. 6), relied on by petitioners (Pet. 9-12), raise factual and legal questions different from those involved here. These cases do not deal with the imposition of constructive dividends upon shareholders

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[8] Indeed, the regulations under Section 61 (Treasury Regulations on Income Tax, § 1.61-1(b) (26 C.F.R.)) state that the statute is not to be applied where there is some other specific Code provision applicable.

but rather involve the allocation, under Section 482, of income among controlled corporations.

In any event, the application of Section 482 in lieu of Section 162 in this case would not have produced a different result, contrary to petitioners' contention[4] (Pet. 8-14). Whatever differences may exist between Sections 162 and 482 are of no consequence in determining whether the Graveses were properly charged with a constructive dividend. The constructive dividend consequence here flows simply from the fact that the Graveses realized immediate economic benefit as a result of having diverted Challenger's earnings to their other corporations. See *Sammons* v. *United States*, *supra*.

4. Finally, petitioners suggest (Pet. 16-18) that the imposition of a constructive dividend represents a constitutionally impermissible penalty. The Commissioner's determination that Challenger's rental payments were excessive produced no additional taxes at the corporate level, however, since amounts disallowed as deductions to Challenger were eliminated by the Commissioner from the taxable incomes of the lessor corporations on the ground that they were non-taxable contributions of capital by the Graveses. The only effect of the Commissioner's action, sustained by the

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[4] The Commissioner filed amended answers in the Tax Court in which he raised Section 482 as an alternative basis for his determination of deficiencies in the income taxes of the Graveses. This alternative position was asserted in the government's brief in the court of appeals (pp. 34-37), and allegations by petitioners (Pet. 7, fn. 7) that the government conceded at oral argument that no constructive dividend would have resulted had Section 482 been applied are unfounded.

courts below, was that the Graveses were required to pay taxes on the funds they diverted from Challenger to their other corporations in the same manner as if there had been a direct distribution to them. There is nothing penal in this result.

CONCLUSION

The petition for a writ of certiorari should be denied.
Respectfully submitted.

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JANUARY 1973.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

* * *

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

* * *

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * *

SEC. 301. DISTRIBUTIONS OF PROPERTY.

* * *

(c) *Amount Taxable.*—In the case of a distribution to which subsection (a) applies—

(1) *Amount constituting dividend.*—That portion of the distribution which is a dividend

(as defined in section 316) shall be included in gross income.

* * *

SEC. 316. DIVIDEND DEFINED.

(a) *General Rule.*—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of it earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

* * *

SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

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Petitioners' Reply to the Brief in Opposition

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Petitioners' Reply to the Brief in Opposition

ARGUMENT

1. Because the substantiality of the conflict between the decision below and that in *Rubin v. CIR,* (C.A. 2, 1970) 429 F.2d 650, is important, we must inform the Court that respondent's statement (Brief in Opposition, pages 7-8) that "On remand, the Tax Court reached the same result under Section 482 as it had reached under Section 61" is false.

The true state of affairs is that described by the Court of Appeals for the Second Circuit, which said that on remand (*Rubin v. C.I.R.*, (C.A.2, 1972) 460 F.2d 1216, 1217-18): "Acting under Section 482, the [tax] court *substantially*

reduced the amounts of additional income and consequent deficiences." (Emphasis ours.)

The actual figures are set forth in Footnotes 1 and 2 at 460 F.2d 1216, 1217-18. They also may be found by comparing 51 T.C. 251 with 56 T.C. 1155, where the first and second Tax Court opinions are reported. The net amounts allocated to the shareholder-employee in the first Tax Court decision were $8,085.09 for the first year, and $42,781.33 for the second year (51 T.C. at 264), and on remand these amounts were reduced to $4,400.00 and $23,500.00, respectively (56 T.C. at 1164). The deficiencies first determined were $5,872.00 for 1960 and $25,304.00 for 1961. "[T]he deficiencies were reduced to $3,917.42 and $13,315.42" (460 F.2d at 1218 fn.2). The reduction in the deficiency for 1960 was 49.9 per cent of the final deficiency and for 1961 the final deficiency was reduced to 52.6 per cent of the original one. The reduction in the deficiency for 1961 nearly equalled the final deficiency for that year, being 90 per cent of it.

Accordingly, the reconsideration under Section 482 on remand was not an idle gesture, and it is not true that the Tax Court "reached the same result" on remand as it had in the original decision, because on remand the Tax Court "substantially reduced" the deficiencies.

2. Since we are filing a reply, we shall mention three other points where our answers might be self-evident.

a. At page 5 of the Brief in Opposition, respondent says that "The test [of the constructive dividend] is whether there is a diminution in the earnings and profits of a corporation which inures to the benefit of a stockholder." To hold that test satisfied here is to permit respondent to lift himself by his own bootstraps. As this transaction was framed by the parties, there was not an over-all diminution of earnings and profits, because the diminution of those of The Challenger was equalled by increases in earnings and

profits of the lessor corporations. If Section 482 were held applicable, those earnings and profits adjustments would be reversed and The Challenger would not have a diminution.

However, under the decision below, the reduction in earnings and profits of The Challenger has occurred because of the payment of the rentals held excessive. The disallowance of the deduction for the rentals, without more, restored the earnings and profits in The Challenger and they would not be reduced if the constructive dividend were not found.

Thus, respondent seems to lift himself by his own bootstraps.

b. Respondent seeks to avoid the conflict between the decision below and *Rubin* by claiming that Section 61 and Section 162 are not parallel because Section 61 is broader in scope than Section 162. In that event, Section 61 is a more suitable section to duplicate Section 482 than is the more narrowly confined section involved here. Respondent's point merely means that compared to *Rubin*, the present case is a fortiori from the *Rubin* result, and this is precisely what we said in our petition. Hence, respondent's analysis emphasizes the conflict.

c. Respondent's reply to the assertion of a conflict with *Holsey v. Commissioner*, (C.A. 3, 1958) 258 F.2d 865, is confined to a footnote (Brief in Opposition, page 7, fn.2), and perhaps the resultant brevity is what has produced the inaccuracies. Contrary to what is said there, there was *not* the certainty that Holsey would ever have gains to be taxed, if he was held to have none in the transaction involved. There was nothing in the facts to suggest that he meant to sell any of his stock and indeed the implication of the facts was to the contrary: the transaction was framed to avoid his having to receive dividends in order to pay off a debt incurred to buy the stock redeemed by his corporation, the payment of real dividends was made more remote by the

transaction. The fact is that these were the incidents of the transaction which caused the Tax Court to hold it taxable, a decision reversed on appeal.

Again contrary to what respondent's footnote claims, the Graves had less "immediate benefit" than Holsey. Their wealth was not increased by having Sparks Development pay off the bank loan instead of The Challenger's doing so, because in either event the bank debt of a wholly owned corporation was reduced in the same amount, and in the cases of the other corporations there were no debts to be paid until they built the casino building to rent to The Challenger,[1] and the same point about the immateriality to the Graves' wealth of which of their corporations paid off the mortgage note is true there.

In each case, there would be no tax unless there was a later sale, but to Holsey, unlike Graves, there was an immediate tax benefit in the form of the transaction, and Holsey won. In deciding that the Graves should not, the court below decided the case in conflict with *Holsey*, and inevitably in a manner to rekindle fires of litigation thought dead.

CONCLUSION

The writ of certiorari should issue.

Respectfully submitted,

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1. The deductibility of this rent is not in question.